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Bankruptcy Credit Bidding Post Fisker: Strategies for Protecting a Credit Bid or Making For Cause Challenges

WEDNESDAY, JULY 29, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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GIMME CREDIT
Presentation on Credit Bidding Cases and Trends

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What is Credit Bidding?

Credit bidding is the right of a secured creditor to use the face amount of its debt as currency to purchase its collateral

At its core, § 363(k) is merely a setoff mechanism, nothing more.

Why is there Credit Bidding?

- A lien constitutes a Property Right
- There is a constitutional prohibition against “taking” of Property
- Credit bidding is more efficient than a secured creditor bidding cash and then demanding that the debtor pay down its secured debt with the proceeds of the secured creditor’s bid

Credit Bidding: The Specifics

- **Who**: Only a creditor holding an allowed claim secured by a valid, perfected lien can credit bid for its collateral.

- **What**: Secured creditor can "credit bid" up to the face amount of its claim (notwithstanding the value of the collateral or how much the creditor paid for the debt).

- **Where/When**: Secured creditor can "credit bid" either as part of a § 363 sale or as part of a § 1129 plan sale.

Section 363(k)

- Section 363(k) governs credit bids and provides that:
  - "At a sale [out of 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" (emphasis added).

Only holders of "Allowed" Claims May Credit Bid

- § 363(k) only permits credit bidding on "allowed claims."
- § 502(a) provides that when a creditor files a proof of claim under § 501, the claim is considered "allowed" until a party in interest objects. For a creditor to place a credit bid, it must file a proof of claim, unless the debtor already has acknowledged that claim on its bankruptcy schedules or otherwise stipulated to the claim.
- When a claim is disputed or its validity cannot be determined, the lender may not credit bid.

Cause

- The Bankruptcy Code does not define what constitutes “cause” for limiting a lender’s ability to credit bid.

- One court noted that “cause” under § 363(k) “is intended to be a flexible concept enabling a court to fashion an appropriate remedy on a case-by-case basis.”

Examples of Cause

- Examples of “cause” to limit credit bidding include:
  - collusion, bad faith, or inequitable conduct;
  - promoting competitive bidding and avoiding the “chilling” of bidding;
  - failure to comply with procedures set by the bankruptcy court; and
  - disputes regarding the validity and priority of liens.

Battles Between Loan to Own-ers and Creditors' Committees Over Cause

- Hedge funds and private equity investors have been criticized for engaging in "loan-to-own" investments where an investor purchases a distressed company's debt at a discount with the intention of credit bidding the full amount of debt.

- Unsecured creditors' committees have attempted to negate the ability of these "loan-to-own" investors from credit bidding by arguing that "cause" under § 363(k) exists under theories of equitable subordination, breach of fiduciary duty and lack of good faith, and by seeking to recharacterize their claims as equity. These arguments have typically been rejected by courts.

Credit Bidding: Then and Now

- Congress adopted Section 363(k) as a means for a secured creditor to protect its investment by preventing a Debtor from selling collateral free and clear of a secured creditors' lien for a price that the secured creditor considered inadequate. The secured creditor can bid debt as its currency instead of cash to encourage bidding or to win the auction and take back its collateral in exchange for releasing the amount of its debt equal to the winning bid.

- Credit bidding has evolved into a tool available to investors in distressed debt who frequently are able to acquire secured debt from existing creditors at a discount and then credit bid the full amount of that debt to acquire the collateral.

Two Types of Cases: Pre-planned and Free Fall

- Pre-planned cases are not just traditional pre-packaged cases where a vote occurs pre-bankruptcy, they are any cases where the Debtor and one or more creditor groups file bankruptcy to execute a pre-negotiated strategy--usually a quick sale.

- Free fall cases are cases where the Debtor files without any pre-negotiated strategy.

The Trends

- According to one study, the percentage of pre-planned cases increased from 40% to 60% between 2008 and 2012.
- According to that same study, pre-planned cases are getting shorter and free fall cases are getting longer.

Why is the Number of Pre-Planned Cases Increasing and Why are they Getting Shorter?

- The Benefit of the Rise of Second and Third Lien Debt: Ability to pre-negotiate with all in-the-money creditors.
- The Cost of the Rise of Second and Third Lien Debt: Litigious Creditors' Committees-- Unsecured Creditors have become a smaller part of the capital structure and are usually out of the money. Their strategy can be to make the bankruptcy so litigious and expensive that the in-the-money creditors pay for peace.
- Rise of Distressed Debt Funds/Loan to Own-ers: Distressed debt funds buy debt at a discount anticipating a quick sale and cash-out or a credit bid and ownership.
- Tougher DIP Loans Due to the Melting Ice Cube: Lenders have learned that they must force the Debtor to complete the sale before the cost of the bankruptcy eats up their collateral.
- More Buyers Today than in 2008

Roadblocks in the Path of the Quick Sale Case

- The Bankruptcy Highway is a toll road: Lenders who want a quick sale case must pay Creditors' Committee fees, administrative and 503(b)(9) claims and perhaps a "tip" for junior creditors.
- Bankruptcy judges frown on sale processes that do not give a Creditors' Committee time to be formed and meaningfully weigh in.
- Bankruptcy judges are growing tired of faster and faster sale processes and are insisting on evidence as to why a sale process must be so fast.

Evidence that May be Used to Prove the "Need for Speed"

- DIP Loan Deadline: However DIP loan deadlines alone are generally not enough, especially if the DIP lender is the stalking horse.
- Stalking Horse Deadlines: Deadlines set by the stalking horse are generally not enough either.
- Limited Liquidity
- Loss of Customers
- Loss of Employees (especially for service businesses)
- All Potential Buyers Already Contacted in Pre-Petition Marketing Process

Benefits of the Quick Sale Case

- With the right evidence, stalking horse buyer can get bid procedures and protections that make it difficult for competitive bidders.
- Buyer can throw out bankruptcy credit priorities and choose what debts to assume (e.g., Chrysler).
- Buyer gets court-order attesting that the sale is free and clear of encumbrances.
- Buyer gets court order that sale price is fair, eliminating fraudulent conveyance risk.

Fisker: Company Overview

- Founded in 2007 by Henrik Fisker and Bernard Koehler
- Maker of Luxury plug-in hybrid electric vehicles
- Raised over $1.2 billion in private capital
- Celebrity clientele: Leonardo DiCaprio, Justin Bieber, Ashton Kutcher among initial buyers

Fisker: Prepetition Timeline and Key Events

- April 22, 2010: Debtors execute $168.5M loan ("DOE Loan") with DOE to develop Karma sedan
- June 2011: Debtors default on DOE Loan; DOE issues "Drawstop Notice" and ceases funding
- May 2013: Fisker declines to file chapter 11 case with open auction of assets on the basis of a $25M stalking horse bid by Wanxiang Automotive, to instead allow an insider group (Hybrid) to first buy Fisker's DOE Loan and then sponsor a sale process
- Oct. 11, 2013: Hybrid (formed by Fisker insiders) wins auction for DOE Loan with bid of $25M
  - succeeds to DOE as Debtors' senior secured lender
- Nov. 13, 2013: Hybrid executes Loan Purchase Agreement with DOE
- Nov. 22, 2013: Hybrid closes on loan purchase, and Fisker files its chapter 11 cases

Fisker: First Day Demands

- Section 363 private sale of all assets, without auction process
  - Extensive prepetition shopping process for Fisker's assets
  - Basis: prepetition auction of DOE Loan conclusively demonstrated that value could not exceed $168.5M amount of Hybrid / DOE Loan
- Immediate and provisional approval of disclosure statement for chapter 11 plan that would release any causes of action against Fisker or Hybrid parties
- Section 363 sale and plan confirmation must be approved by January 3
- Up to $500K to be made available for GUCs (consisting of about $100M, not including Hybrid deficiency)

Fisker: Post-filing Timeline

- November 22, 2013: Petition date
- December 5, 2013: Committee formation
- December 30, 2013: Objection deadlines (plan, sale, DIP)
- January 3, 2014: Hearing to approve plan, sale, DIP

Fisker: Committee's "25 Day Game Plan"

- Strategically, to not divorce sale / DIP from chapter 11 plan process
  - Sale would define and limit pot of value
  - Need to retain "good faith" and "fair and equitable" conditions to relief
- Analyze perfection of Hybrid liens
  - World-wide IP
  - Finland operations
- Analyze causes of action
  - Formal interviews
  - Informal discovery
- Find a competitive buyer
- Find a junior DIP loan to extend runway beyond January 3

Fisker: December 30 Deliverables

- Full APA with Wanxiang for $10M value increment
  - Subject to competitive bidding on market terms
  - But conditioned on elimination or limitation of credit bidding
- STN Motion as to estate causes of action, with full draft complaint ready to be filed
  - Breach of duty of loyalty
  - Perfection defects
- Fully subordinated DIP loan to fund 60 day extension of sale process

Fisker: January 10 Stipulated Facts Between Debtors and Committee

- Highest value for estate would be achieved only by sale of all Fisker assets as an entirety
- If Hybrid's credit bid was limited or capped, strong likelihood of competitive auction
- If no credit bid limitation or cap, no realistic possibility of auction
- Assets to be sold comprised of three "buckets," each material:
  - properly perfected Hybrid collateral;
  - assets not properly perfected in Hybrid's favor; and
  - "question marks" — assets whose perfection were disputed

Fisker: January 10 Agreements Between Debtors and Committee

- Any misconduct by Debtors or others would not be alleged at the January 10 hearing
- If Court did not limit or cap credit bid, Committee would withdraw all oppositions to Sale, DIP Loan, Plan, etc.
- Credit bid decision should be based exclusively on Committee's positions that:
  - credit bidding is not permitted where at least some material liens are in bona fide dispute;
  - "cause" here would be solely the goal of facilitating competitive auction; and
  - "cause" exists due to presence of encumbered, unencumbered and disputed assets, each material in amount

Fisker: The Credit Bid Decision

- Court capped Hybrid's credit bid amount at $25M — the price Hybrid paid for DOE Loan
  - "Cause" includes "any policy advanced by the Code." Phila. Newspapers, 599 F.3d at 315-16.
  - Absent cap on credit bid, not only would there be "chilled“ bidding, there would be no bidding.
  - Uncertain status of Hybrid's collateral — lienholder may not credit bid on lien if validity of lien has not been determined.
  - "Unfair, hurried process": petition filed 3 days before Thanksgiving, insistence on confirmation 2 days after New Year’s Day

Fisker: Bases for the Court's Decision

- "Cause" to deny credit bidding includes desirability of value-enhancing, public auction process
  - does not require inequitable conduct
- Material issues as to collateral perfection
- Judges don't like to be artificially rushed
  - Hybrid's "drop dead" date of Jan. 3, 2014 left only 24 business days for parties to challenge Sale Motion
  - J. Gross: drop dead date was "pure fabrication, designed to place maximum pressure on creditors and the Court."
- Existence of ready, willing, and able second bidder (Wanxiang) that would participate only if credit bid were capped

Is the Fisker Ruling a Surprise?

- Bad facts make bad law.
- Credit bidding can chill bidding under certain circumstances.
- Any "deep pocketed" bidder can chill bidding.

The Facts of the Fisker Case Dictated an Anti-Credit Bidding result

- The secured debt had been purchased at a deep discount.
- There were material assets upon which the secured debt holder did not have perfected liens.
- Any purchaser was going to want both assets upon which there were liens and assets upon which there were no liens.
- There were other bidders for all assets who would not bid against the secured debt holder because of its ability to credit bid on the assets upon which it had perfected liens.

Credit Bidding Can Chill Bidding Under Certain Circumstances

- Where a secured debt holder has a perfected lien on all assets, a credit bid is what it is.
- Where a secured debt holder does not have perfected lien on all assets, a credit bid on part of the assets may chill bidding on all of the assets.
- If a secured debt holder bought its debt for 25% of par, it is effectively bidding 25 cent dollars for the secured assets, enabling it to bid much more than other bidders for the unsecured assets.
- Chilling effect is particularly bad in cases where any buyer needs both secured and unsecured assets.

Any "Deep Pocketed" Bidder Can Chill Bidding

- Advantage of a secured debt holder that bought its debt for 25% of par is arguably no different than the advantage of a bidder that has more cash and makes it known it is willing to pay more than other bidders (e.g., a large strategic buyer).
- In either scenario, competing bidders are likely to stay away.
- Why then, should credit bids be subjected to court imposed limitations, when bidders with deep pockets are not?

Credit Bidding After Fisker

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In re Free Lance-Star Publishing Co. 512 B.R. 798 (Bankr. E.D. Va. 2014)

- Debtors published a newspaper, and also ran a commercial printing business and radio stations
  - Assets used in the radio business called “Tower Assets”
- Prepetition lender was BB&T Bank, which sold its loan to DSP Acquisition LLC in June 2013
  - In June/July 2013, DSP and the Debtors discussed a consensual restructuring
  - DSP asked Debtors to grant liens on the Tower Assets, which were unencumbered
  - Restructuring negotiations broke down in August 2013
  - When negotiations broke down, DSP unilaterally filed UCC financing statements covering the Tower Assets

In re Free Lance-Star Publishing Co. 512 B.R. 798 (Bankr. E.D. Va. 2014)

- In Summer 2013, 90 days after filing its UCC financing statements, DSP restarted bankruptcy negotiations, pressing Debtors for a quick chapter 11 filing
  - In negotiations, DSP resisted conducting a comprehensive marketing of Debtors' assets
  - DSP insisted that Debtors' marketing materials prominently note its right to credit bid
  - Debtors' projections showed no need for a DIP facility; DSP insisted on one so it could acquire further liens on the Tower Assets
  - When Debtors declined the offered DIP loan, negotiations with DSP again broke down
  - After negotiations broke down, DSP filed additional financing statements without agreement of, or notice to, Debtors

In re Free Lance-Star Publishing Co. 512 B.R. 798 (Bankr. E.D. Va. 2014)

- Debtors filed for chapter 11 in January 2014
  - DSP objected to use of cash collateral, and asked for liens on the Tower Assets as adequate protection
  - DSP did not disclose its prior financing statements filed against the Tower Assets
  - Court found DSP adequately protected and denied liens on Tower Assets
- Debtors filed a motion seeking approval of bidding procedures for sale of substantially all assets
  - Bidding procedures allowed DSP to credit bid on assets on which it held valid liens
  - Debtors sought to maximize value of assets for the benefit of all creditors

In re Free Lance-Star Publishing Co.
512 B.R. 798 (Bankr. E.D. Va. 2014)

- DSP filed adversary proceeding seeking declaration it held valid liens on the Tower Assets and moved for summary judgment and Debtors cross moved
- Court acknowledged the ordinary right of creditor to credit bid, citing *RadLAX Gateway Hotel, LLC*
- But *Free-Lance* court held that credit bidding was "not an absolute right" and cited *Fisker Auto. Holdings, Inc.* and *Philadelphia Newspapers, LLC* to establish that credit bidding may be limited or denied "for cause"

In re Free Lance-Star Publishing Co. 512 B.R. 798 (Bankr. E.D. Va. 2014)

- Debtors argued three grounds to limit DSP's credit bidding:
  - No valid lien on Tower Assets
  - DSP's inequitable conduct chilled the bidding
  - Not permitting DSP to credit bid will restore vitality to auction
- Court found DSP had engaged in inequitable conduct
  - Secret filing of liens on Tower Assets
  - Failure to disclose filing of liens
  - Pressure on Debtors to shorten marketing period and discourage robust auction

In re Free Lance-Star Publishing Co. 512 B.R. 798 (Bankr. E.D. Va. 2014)

- Court held that DSP's loan-to-own strategy and other inequitable conduct was intended to chill the bidding and interfere with fair sale process
- Court limited DSP's right to credit bid to $13.9 million of assets on which it had a valid lien
  - DSP's total claim was approximately $51 million, so the reduction was approximately 73%
- DSP sought interlocutory appeal of Bankruptcy Court's ruling, but District Court refused to hear it, relying on District Court's refusal to hear interlocutory appeal in *Fisker*

In re Charles Street AME Church

- Charles Street AME ("CSAME") Church in Boston owned two parcels of real estate encumbered by mortgages held by OneUnited
- CSAME filed a 363 motion to sell all assets and sought to bar OneUnited from credit bidding or require OneUnited to make a $210,000 cash bid to cover break-up fee expenses in auction
  - CSAME alleged that it held claims sounding in "predatory lending" against OneUnited, which, if favorably decided, would have fully offset OneUnited's claim
  - CSAME argued that OneUnited's claim was subject to *bona fide* dispute

In re Charles Street AME Church

- Bankruptcy Court noted that a *bona fide* dispute has been cited as a basis to deny or limit credit bidding
  - But the record showed no dispute as to validity, perfection or priority of OneUnited's claims
  - Because no dispute as to validity of OneUnited claims, only existence of unliquidated counterclaims, court did not limit OneUnited's right to credit bid, except to require OneUnited to bid $50,000 in cash to cover break-up expenses
  - Court expressly disavowed reliance on *Fisker*

In re RML Development, Inc.
Case 13-29244 (Bankr. W.D. Tenn. 2014)

- Debtor that owned two apartment complexes filed motion to sell substantially all assets
- Mortgage lender Silverpoint sought right to credit bid at sale and debtor objected due to dispute as to amount owed
  - Silverpoint claimed it was owed $2.54 million; debtor contended debt was $2.35 million
- Court held that Silverpoint would be allowed to credit bid the undisputed portion of its claim, i.e., $2.35 million:

"***The bankruptcy court should only modify or deny a § 363(k) credit bid when equitable concerns give it cause. This court believes such a modification or denial of credit bid rights should be the extraordinary exception and not the norm***."

Radio Shack

- Prepetition, Radio Shack had a $585 million revolving loan facility originated by GE Capital
- Radio Shack also had a $250 million term facility for which Salus Capital Partners (“Salus”) acted as agent
- Intercreditor agreement specified payment priorities between facilities

Radio Shack

- In 2014 GE Capital sold its position to Standard General, which restructured the revolving facility, reducing the revolver portion and terming out the balance
- After Radio Shack filed for Chapter 11, Standard General made a bid of approximately $145 million, including a $117 million credit bid
- Salus filed an adversary seeking to limit Standard General's right to credit bid to $111 million
  - Salus argument based on priority provisions of intercreditor agreement, and did not alleged misconduct or inequitable behavior by Standard General

Radio Shack

- Salus made its own bid, which also contained a credit bid component
- Ultimately Standard General made a credit bid of $112 million as part of its winning bid of $140 million
  - Bid was reduced because Radio Shack name and intellectual property removed from first auction
  - Standard General later won the auction for the intellectual property for $26 million

Lessons from Post-Fisker Cases

- Right to credit bid was protected by Supreme Court in RadLAX, but is not absolute and can be modified for cause
  - Because cause is not defined in 363(k), it is an inherently equitable concept
  - Cases suggest strong evidence of lender misconduct or inequitable behavior typically present when court limits credit bidding, such as interfering with fair auction process
  - Boilerplate allegations are not likely to be sufficient
  - It helps to have a strong alternative bidder present, as in Fisker

Credit Bidding

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July 29, 2015

Section 1111 of the Bankruptcy Code

- Section 1111(b)(1) of the Bankruptcy Code provides that a secured claim will be treated as a recourse claim, unless:
  - the class of which the creditor is a part makes an election to have its claim treated as fully secured under section 1111(b)(2), or
  - the creditor does not have recourse and the property securing its lien "is sold under section 363 of [the Bankruptcy Code] or is to be sold under the plan."
- Section 1111(b)(2) of the Bankruptcy Code provides, "[i]f such an election is made, then notwithstanding section 506(a) of [the Bankruptcy Code], such claim is a secured claim to the extent that such claim is allowed."
- Absent a section 1111(b) election or a sale of collateral, an undersecured creditor will have a secured claim to the extent of the value of its collateral and an unsecured claim for any deficiency.
- Upon an election, the entire allowed claim is treated as secured and there is no unsecured deficiency claim.

Section 1111 of the Bankruptcy Code

- The section 1111(b) election protects a secured creditor against lowball valuations.
- Why might a low value be assigned?
  - Depressed market conditions
  - Valuation error.

Section 1111 of the Bankruptcy Code

- The 1111(b) election is not available if, among other things, the creditor has recourse and the collateral "is sold under section 363 of [the Bankruptcy Code] or is to be sold under [a chapter 11] plan."
- Why do we have this exception?
  - Protection against low valuation is not necessary when the market determines the value of the collateral.
  - Creditors do not need the protections of section 1111(b) if the collateral is sold because they have the right under section 363(k) to credit bid at the sale.
- Section 1111(b) and 363(k) are, in that sense, closely intertwined.

Baker Hughes Oilfield Operations, Inc. v. Morton (In re R.L. Adkins Corp.), 784 F.3d (5th Cir. Tex. 2015)

- Holding: Though it failed to exercise it, creditor was granted the right to credit bid at the sale of its secured interest and, accordingly, creditor could not make an 1111(b) election.
- Facts:
  - July 2011 - involuntary chapter 7. One month later, converted to a chapter 11.
  - Potential purchaser proposed a chapter 11 plan at the end of 2012 under which the debtor would sell 90 mineral leases and some wells in a private bulk sale.
  - Creditor had a lien on four mineral leases and one well as security for claims aggregating approximately $320,000, but creditor's claims were secured only to the extent of $39,000.
  - March 4, 2013 - creditor filed 1111(b) election.
  - May 13, 2013 - plan confirmed. No objection, no appeal.
  - July 3, 2013 - bankruptcy court denied 1111(b) election. District Court affirmed.

Baker Hughes Oilfield Operations, Inc. v. Morton (In re R.L. Adkins Corp.), 784 F.3d (5th Cir. Tex. 2015)

- Majority: Creditor could not make an 1111(b) election because property was sold and creditor had the right to credit bid.
  - Even though creditor never tried to exercise the right to credit bid, it had it.
  - The plan said it had the right.
  - The confirmation order found it had the right.
  - Any uncertainty on the part of the creditor could have been raised at confirmation or by objection or even appeal of the confirmation order.

Baker Hughes Oilfield Operations, Inc. v. Morton (In re R.L. Adkins Corp.), 784 F.3d (5th Cir. Tex. 2015)

- Concurrence: The argument that creditor waived its 1111(b) election is "persuasive."
- But…
  - "The majority unwisely steps beyond this narrow holding . . . when they appear to conclude that the bulk sale of the debtor's assets, which occurred outside a public auction and included multiple assets burdened by multiple liens, nevertheless protected a secured creditor's right to credit bid."
  - The plan and confirmation order "perfunctorily incant[ed]" section 363 does not mean that the creditor's right to credit bid was adequately protected.
  - Section 1111(b) "offers no guidance as to what constitutes a sale 'under § 363' or 'under the plan.'"
- The concurring judge provided guidance on how to protect a secured creditor.
  - Timely rulings on 1111(b) elections before plan confirmation.
  - Allow 1111(b) elections if the terms of a sale fail to protect a credit bid.
  - Transparent, broadly publicized auctions.

Baker Hughes Oilfield Operations, Inc. v. Morton (In re R.L. Adkins Corp.), 784 F.3d (5th Cir. Tex. 2015)

- Unlike the other decisions discussed, this is not a case addressing the "for cause" limitation in section 363(k).
- *Adkins* could be viewed as a case regarding when a right to credit bid is waived.
- Perhaps even more interesting is the questions *Adkins* raises about the nature of the right to credit bid and its interaction with the rest of the Bankruptcy Code.
- The concurring judge was bothered by how we should treat a credit bid in the context of bulk asset sales, which are commonplace in chapter 11.
  - Hypothetical: "A debtor proposes to reorganize by a bulk sale of its manufacturing plant and assets to a third party. Separate liens exist on the facility, its machines, inventory, and the real property. This transaction could ensnare first lien secured creditors on the various pieces of collateral such that none could effectively credit bid for its discrete interest."
- Other cases have grappled with issues relating to allocation and bids by secured creditors having liens on less than all of the assets subject to the sale transaction.

ABI Commission to Study the Reform of Chapter 11

- Surveyed the existing law, including citing *Fisker*, *Free Lance-Star*, and *RML*.
- "[U]ltimately agreed to maintain the current standard under section 363(k)…"
- However, recommended that "the potential chilling effect of a credit bid alone should not constitute cause…."
- Instead, courts should attempt to mitigate chilling through the auction and sale procedures approval process.