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Aeropostale Reaffirms Secured Lender Right To Credit Bid


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Law360, New York (August 30, 2016, 12:04 PM ET) -- In a significant victory for secured lenders, Judge Sean Lane of the U.S. Bankruptcy Court for the Southern District of New York entered a decision on Friday that reaffirmed a secured lender's right to credit bid under Section 363(k) of the Bankruptcy Code and limited the circumstances under which a debtor could defeat such right.

What is Credit Bidding?

Section 363(f) of the Bankruptcy Code permits a debtor, under certain specified circumstances, to sell property of the debtor's bankruptcy estate free and clear of liens, claims and interests. In some cases, the debtor may do so regardless of whether the lender with a lien on those assets consents to the sale. Section 363(k) of the Bankruptcy Code, however, recognizes the vested property rights that secured lenders have in their collateral by permitting secured lenders to "credit bid" their allowed secured claims in any sale of that collateral under the Bankruptcy Code. In other words, if a lender has a secured, first-priority loan in the face amount of $100 million, it can bid up to $100 million for its collateral without paying cash and can simply apply the loan amount as a credit against the purchase price. Of course, if other lenders have liens with a higher priority, then the claims of those lenders must be satisfied before the junior secured lender may credit bid. Section 363(k) does permit a bankruptcy court to limit a secured creditor's right to credit bid "for cause shown," but it does not specify what constitutes "cause."

Previous Attempts in Bankruptcy Cases to Limit Credit Bidding

Under most circumstances, one would presume that credit bidding is fairly noncontroversial — if the lender has a first-priority lien on the assets being sold, then that lien would attach to the proceeds of any sale, and eventually the lender's claim likely would be paid out of the sale proceeds. Therefore, from a lender's perspective, even if it pays cash, the cash eventually should get "roundtripped" to the lender and paid to it.

Nothing in the Bankruptcy Code, however, actually requires immediate payment of the cash proceeds from a 363 sale to a lender and, in fact, it is easy to imagine circumstances in which the debtor might attempt to replace a lien on cash collateral with, for example, a lien on property of equivalent value and then attempt to stretch out repayment of the lender's claim. In addition, absent a credit bid, the lenders' collateral may get sold for a price significantly below the amount owed on its debt. Notwithstanding a lender's first-priority security interest, creditors committees and debtors often express concern about "chilling" the bidding on an asset by allowing a secured lender with a large claim to credit bid. Citing the American Bankruptcy Institute Commission's Report on Chapter 11, the Aeropostale court noted that all credit bidding chills bidding to some extent and, therefore, the risk of chilling bidding, by itself, cannot justify limiting a lender's right to credit bid. (Unfortunately, the court, perhaps unnecessarily, distinguished Aeropostale's situation from other decisions by noting that credit bidding would not chill bidding to the point at which other bidders would not participate.)

In 2014, the Delaware bankruptcy court fanned the flames of the anti-credit bidding argument by holding that the secured lender in Fisker Automotive's Chapter 11 case was limited to credit bidding a secured claim it had purchased by the amount the lender had paid and not the full amount of its claim. In re Fisker Auto. Holdings Inc., 510 B.R. 55 (Bankr. D. Del. 2014). The case was somewhat sui generis, including that the secured lender only had a perfected security interest on some of the collateral being sold, questions had been raised as to whether the lender had a properly perfected secured claim, and the lender (who was the stalking horse bidder) had pushed for an expedited (24-day) sale process without any justification for doing so. Moreover, the court found that, without so limiting the lender's credit bid, no other party was interested in participating in the auction. At least one other court post-Fisker boarded the anti-credit bidding train, In re Free Lance-Star Publishing Co. of Fredericksburg, VA, 512 B.R. 798 (Bankr. E.D. Va. 2014), and it became part of the unofficial playbook for unsecured creditors committees to raise the argument each and every time a secured lender sought to credit bid. Notwithstanding the initial success with Fisker and Free Lance-Star, bankruptcy courts did not rush to accept the invitation to apply Fisker broadly.

These decisions came against the backdrop of the U.S. Supreme Court's 2012 decision in Radlax Gateway Hotel LLC v. Amalgamated Bank, 132 S. Ct. 2065 (2012), in which the court held that a debtor could not deprive secured lenders of their right to credit bid even if the bankruptcy sale was not conducted during the case under Section 363 of the Bankruptcy Code, but, instead, was conducted as part of the debtor's plan of reorganization.

Aeropostale Decision

In light of the Supreme Court's ruling, one might think it would be hard to challenge credit bidding in the absence of a court finding (1) that a secured lender did not have a valid claim or validly perfected security interest in the collateral being sold, (2) that the claims of the secured lender could be "equitably subordinated" under Section 510(c) of the Bankruptcy Code to the claims of other creditors (including unsecured creditors), or (3) the claims of the secured lender should be "recharacterized" as capital contributions. If one puts aside the questions raised by the court's observation that limiting credit bidding would not eliminate competitive bidding, that is essentially what the bankruptcy court held in Aeropostale. The first argument is often a fairly straightforward claim allowance and lien perfection analysis (with questions about preference and fraudulent transfer sometimes mixed in) and is the traditional method of attacking credit bidding. Equitable subordination and recharacterization, however, have become two commonly used threats, but are very difficult to prove. The Aeropostale debtors found out just how difficult.

The Court Refuses to Equitably Subordinate the Sycamore Lenders' Claims

The Aeropostale debtors sought to block their secured lenders, affiliates of Sycamore Partners, from credit bidding by seeking to equitably subordinate the lenders' claims to those of the debtors' other creditors. If a secured claim is equitably subordinated, it follows that the claim should not be entitled to credit bid unless and until the claims of the higher priority creditors are paid in full. Equitable subordination is a remedial measure codified in Section 510(c) of the Bankruptcy Code and requires the party requesting equitable subordination to demonstrate inequitable conduct by the creditor that causes injury to other creditors or confers an unfair advantage on the creditor. A breach of contract, fraud, misrepresentation or other similar conduct may constitute inequitable conduct. Once the party seeking equitable subordination demonstrates that inequitable conduct has occurred, though, it must tie that inequitable conduct to harm caused or unfair advantage created by such inequitable conduct. If it does so, then the bankruptcy court should subordinate the creditor's claim to the extent necessary to remedy the harm.

The Aeropostale debtors asserted three types of inequitable conduct in support of their equitable subordination claims: one of the debtors' suppliers, an indirect subsidiary of Sycamore Partners, had breached its sourcing agreement with the debtors, (2) the actions of the various Sycamore-affiliated entities were "part of a secret and improper plan to buy Aeropostale at a discount," and (3) the Sycamore entity that owned Aeropostale's stock had improperly sold such stock while in possession of material, nonpublic information.

The court rejected the Aeropostale debtors' breach of contract argument. After finding that Aeropostale's management had been miscalculating the company's liquidity under the sourcing agreement and was not even aware of credit review rights the supplier had if liquidity dropped below a certain threshold, the bankruptcy court noted that the mistake and lack of awareness of a key contract provision "undermine the credibility of the Debtors' management." The court determined that the actions of the supplier did not breach the terms of the sourcing agreement and, in fact, had been commercially reasonable under the circumstances.

The court also rejected the Aeropostale debtors' claim that the affiliated Sycamore parties had engaged in a conspiracy to push Aeropostale into bankruptcy and "buy it on the cheap." Among other things, the court noted that, at the time Sycamore began investing in Aeropostale and its subsidiary had entered into the sourcing agreement with Aeropostale, Sycamore had every economic incentive to want Aeropostale to succeed. Moreover, the Sycamore-affiliated lenders only designated two out of the five members of the Aeropostale board, and, therefore, did not control the board. The court also found that the wearing of multiple hats by Sycamore-affiliated parties — equity holder, secured lenders and supplier under the sourcing agreement — did not, by itself, support an equitable subordination claim. Indeed, it noted that the roles of lender and supplier "were not forced upon" Aeropostale, but were, in fact, "agreements negotiated at arms-length." Finally, the court rejected the proposition that the Sycamore parties' discussions among themselves about a potential Aeropostale bankruptcy and planning for such bankruptcy evidenced a secret plan, finding that actions designed to protect a party's interest are not evidence of inequitable conduct: "the question is whether a party planning to exercise its rights as a creditor takes actions that step over the line into impermissible conduct to further its interest in a way that damages a debtor or the bankruptcy estate. The Court does not find such conduct here."

The bankruptcy court did find, though, that the Sycamore-affiliated equity owner had sold its Aeropostale stock at a time when it possessed nonpublic information. Nevertheless, the court refused to order equitable subordination on this ground because it held that the debtors had failed to demonstrate that they or their creditors had been harmed as a result of the sale. Whether the sale "undermined ... public's regard of" Aeropostale was irrelevant, the court held, "because this is not the type of harm that courts are concerned about when determining whether to equitably subordinate a claim." Based upon its finding of a lack of harm, the court concluded that it did not need to determine whether the information was material.

The Court Refuses to Attribute the "Bad Acts" of One Sycamore-Related Party to Another on the Basis of Alter Ego Theory

Although the Aeropostale court held that none of the facts justified application of equitable subordination, the court went on to determine whether it even was appropriate to consider the actions of the Sycamore-related equity owner and the Sycamore-related supplier in determining whether to allow the Sycamore-related lenders to credit bid their secured claims. It held that such actions should not be considered unless the debtors could prove facts that would warrant treating those entities as alter egos of Sycamore. Notably, in undertaking its analysis, the court seemed to focus more on whether the supplier or the equity owner could be considered an alter ego of Sycamore and less on whether either would be considered an alter ego of the separate Sycamore-related lenders.

The standard for finding an alter ego relationship under Delaware law (the law of the state of the Sycamore entities' organization) is that there has been "such complete domination and control that the controlled entity is a mere shell." As to the supplier, the court found that the supplier had been in business for over 40 years and was owned by someone other than Sycamore for the majority of that time. Although Sycamore was a party to an advisory agreement with the supplier and negotiated the sourcing agreement with Aeropostale, the supplier otherwise acted independently, including having its own third-party credit facility and having its separate management team involved in discussions relating to the sourcing agreement.

The court found that Sycamore's relationship with the equity owner was more problematic and found that Stefan Kaluzny, Sycamore's co-founder, "wore different hats with respect to the various Sycamore Parties." The court also found, though, that "this alone is insufficient to pierce the corporate veil." In the end, despite noting that the parties had not provided sufficient factual or legal information to determine the corporate separateness of the equity owner from the other Sycamore-related parties, the court determined that it need not reach the issue given its conclusions on equitable subordination and credit bidding.

The Court Refuses to Recharacterize the Sycamore Lenders' Claims

Finally, the bankruptcy court rejected the debtors' attempt to "recharacterize" the secured loans as equity investments. The court noted that, although the debtors raised the recharacterization issue in their motion, they did not brief the issue in their trial brief. Nevertheless, the court went through the list of factors from the oft-cited case, Bayer Corp. v. MascoTech Inc. (In re AutoStyle Plastics Inc.), 269 F.3d 726 (6th Cir. 2001), and concluded that the debtors had failed to establish the "vast majority" of the factors.

As to the factors weighing against recharacterization, the court found that the parties referred to the transaction as loans, the loan had a fixed maturity date and required scheduled amortization payments, the loan was secured by a lien on substantially all of the debtors' assets, the actual lender had no equity in the debtors (although its affiliate held 8 percent of the equity, a level that the court concluded did not change the analysis), other unaffiliated lenders had made financing proposals, the loan was senior to all claims other than those of the debtors' prepetition asset-based lenders, and the loan proceeds were not used to purchase capital assets but, instead, were used for working capital.

If a loan does not bear interest, that weighs in favor of recharacterization. Although the secured lenders' loan did not bear interest, the court found that this factor was not dispositive as the loan was structured to create economic returns through the supplier's sourcing agreement.

The court gave little weight to two of the traditional AutoStyle recharacterization factors. First, although the debtors likely were inadequately capitalized at the time of the loans, the court followed the current trend among bankruptcy courts to give that factor little weight, reasoning that Aeropostale "sought out financing to fund its turnaround — it would thus be inappropriate to penalize the Term Lenders for lending to a distressed company." Second, although no sinking fund requirement existed (a factor that seems inapplicable to most loans today), the court found that the existence of the security interest over all the debtors' assets rendered a sinking fund unnecessary.

Conclusion

Fisker triggered shock waves among lenders that the bankruptcy courts were signaling an inclination to find a lower standard of "cause" for limiting credit bidding. Judge Lane's decision in Aeropostale not only resets the bar to where it was before Fisker, but also demonstrates that, notwithstanding the popularity of threats of equitable subordination and recharacterization, such claims often are difficult to prove in the context of sophisticated commercial transactions.

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