Making the Most of an Undersecured Creditor's Claim:
The Nuances of Credit Bidding in Bankruptcy

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The ability of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to sell assets free and clear of liens and other competing interests has long been recognized as one of the most important vehicles for restructuring a debtor's balance sheet and generating value to fund distributions to creditors pursuant to a plan of reorganization or liquidation. If property is sold free and clear of a lien, the rights of the secured creditor are adequately protected even though it is denied access to its collateral if, as is done in most cases, the lien is transferred to the proceeds of the sale. Those proceeds will later be distributed to the secured creditor to the extent of the allowed amount of its secured claim either pursuant to a chapter 11 plan (at confirmation or over time) or in accordance with the liquidation scheme established under chapter 7 of the Bankruptcy Code.

A secured creditor whose collateral is to be sold free and clear is also afforded another important right in connection with the sale. Section 363(k) of the Bankruptcy Code gives a secured creditor the right to credit bid its claim. In this way, the creditor can ensure that the collateral is not sold for less than the face amount of the debt it secures. It is well settled among bankruptcy and district courts that a secured creditor can credit bid the full amount of its claim at a sale, even if the claim amount exceeds the value of the collateral. However, no court of appeals at the circuit level had addressed this issue directly until the Third Circuit handed down its ruling in *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Systems Corporation)*. There, the Court of Appeals held that certain lenders' credit bids were not capped at the economic value of the collateral securing their claims.

Sales Free and Clear of Liens in Bankruptcy

Under section 363(b) of the Bankruptcy Code, a trustee or DIP may use, sell or lease property of the estate outside the ordinary course of the debtor's business with bankruptcy court approval. In addition, under section 363(f), the sale may be "free and clear of any interest in such property of an entity other than the estate" provided it satisfies any one of certain specified conditions. These include, among other things, if applicable non-bankruptcy law permits a sale free and clear, if the sales price exceeds the aggregate value of all liens encumbering the property, or if the interest is in bona fide dispute.

A bankruptcy court's power to approve sales free and clear of competing interests without the consent of the party asserting the interest has long been recognized. Free and clear sales promote the expeditious liquidation of estate assets by avoiding delay attendant to sorting out disputes concerning the validity and extent of competing interests, which can later be resolved in a centralized forum. They also facilitate the estate's realization of the maximum value possible from an asset. A prospective buyer would discount its offer significantly if it faced the prospect of protracted litigation to obtain clear title to an asset. Pending the bankruptcy court's resolution of any disputes, the non-debtor is entitled to "adequate protection" of its interest. This most commonly takes the form of a replacement lien on the proceeds of the sale.

Credit Bidding and Protection of Undersecured Creditors

Section 363(k) of the Bankruptcy Code provides that at a sale under section 363(b) 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." In most cases, a secured creditor has the right to credit bid only if the validity or extent of its lien is not subject to bona fide dispute.

The credit bid mechanism preserves the secured creditor's bargain by ensuring that either its debt is paid in full or the collateral stands in its place. It is an important protection afforded to a secured creditor — especially an undersecured creditor — whose collateral is being liquidated during the course of a bankruptcy case. If the secured creditor believes that its collateral will be sold for less than its actual value, the creditor has the option to take the collateral by credit bidding its debt. Alternatively, it can simply allow the sale to run its course, after which its lien will typically attach to the proceeds with the validity and priority that existed prior to the sale. If collateral is sold under a chapter 11 plan rather than in a non-ordinary course sale under section 363(b), a dissenting secured creditor may exercise its rights under section 363(k) in connection with the sale.

The protection given to secured creditors in section 363(k) is closely related to rights found in another provision of the Bankruptcy Code. Section 1111(b) (which applies only to chapter 11 cases) provides that a secured claim will be treated as a recourse claim even if the claim is not actually recourse to the debtor by contract or under applicable state law. This means that the creditor will have a secured claim to the extent of the value of its collateral and an unsecured claim for any deficiency, unless the class of claims of which the secured creditor is a member makes a "section 1111(b) election" to have all claims in the class treated as fully secured.

The provision was designed to prevent the debtor from confirming a chapter 11 plan that deprives a non-recourse undersecured lender of its right to foreclose on its collateral by retaining the property (with the hope that it will later appreciate in value), stripping down the secured claim to the value of the collateral at the time of confirmation and paying pennies on the dollar (or nothing at all) in respect of the unsecured deficiency claim. Under section 1111(b), the debtor may retain possession of the property, but a creditor holding a lien on the property can elect to have its claim treated as if fully secured, and that status must be reflected in any treatment of the creditor's claim under a chapter 11 plan. Section 1111(b) does not apply if the property is to be sold under either section 363 or a chapter 11 plan. In that event, section 363(k) applies to protect an undersecured creditor's rights.

Parties opposing credit bidding sometimes rely on section 363(k)'s reference to “a lien that secures an allowed claim” to argue that a secured creditor may not credit bid the full face value of its claim or may credit bid only the value of its collateral on the date of the sale. This position arguably is buttressed by section 506(a) of the Bankruptcy Code, which provides that a claim secured by collateral is an allowed secured claim only to the extent of the value of any collateral, with any deficiency being classified as a separate unsecured claim. Arguably, if an "allowed" secured claim is capped at the value of the collateral under section 506(a), section 363(k) should be read to limit the amount of a credit bid to the allowed amount of a secured claim rather than the full face value of the underlying debt. This was the question addressed by the Third Circuit in *SubMicron Systems*.

SubMicron Systems

Semiconductor tool designer and manufacturer SubMicron Systems Corporation and its affiliates (collectively, "SubMicron") were forced to restructure their debt several times in the late 1990s in an effort to weather a steep downturn in the semiconductor industry. In 1997, SubMicron's debt structure consisted of: (i) a $15 million working capital facility provided by Greyrock Business Credit secured by first priority liens on substantially all of SubMicron's assets; (ii) $20 million in senior subordinated notes (the "1997 Notes") held by KB Mezzanine Fund II, LP ("KB") and its managing partner, Equinox Investment Partners, LLC (collectively referred to as "KB/Equinox"), secured by second priority liens on substantially all of SubMicron's assets; (iii) two tranches of junior subordinated notes in favor of The BOC Group, Inc. in the aggregate amount of $13.7 million which, being secured by third priority liens on substantially all of SubMicron's assets, were not at issue in SubMicron.

SubMicron was compelled to borrow more during the next two years as its financial problems worsened and Greyrock reduced the maximum availability under the company's working capital facility. In 1998, the company issued $4 million in senior subordinated notes (the "1998 Notes") to KB/Equinox and Celerity Silicon LLC pari passu with the 1997 Notes. The following year, it issued approximately $7 million in notes (the "1999 Notes") to KB/Equinox and Celerity, which loaned an additional $4 million to SubMicron during the course of that year to fund the company's critical working capital needs. Both the 1999 Notes and the additional borrowing from KB/Equinox and Celerity (collectively, the "1999 Funding") were booked as secured debt, although no notes were issued to evidence the $4 million in additional funding. By June of 1999, three KB/Equinox principals or employees and one employee of Celerity sat on SubMicron's board of directors — only SubMicron's CEO remained as a management representative on the board.

SubMicron began acquisition discussions with Sunrise Capital Partners LP in the summer of 1999. KB/Equinox, rather than SubMicron's management, conducted the negotiations, which resulted in an agreement whereby Akrion LLC, an acquisition entity created by Sunrise, would acquire the company as part of a pre-packaged chapter 11 case. It was generally understood at the time that absent an agreement with Sunrise, SubMicron would be forced to liquidate, leaving secured creditors other than Greyrock with pennies on the dollar and unsecured creditors and shareholders with nothing.

Under the agreement, KB/Equinox and Celerity, in exchange for a 32 percent interest in Akrion, would contribute their secured claims (i.e., the 1997 Notes, the 1998 Notes, and a portion of the 1999 Funding) to allow Akrion to credit bid the claims in a sale under section 363(b) of the Bankruptcy Code. In addition, at the closing of the sale SubMicron would be required to disburse $5.5 million to KB/Equinox and Celerity in partial repayment of the 1999 Funding.

The SubMicron debtors filed for chapter 11 in September of 1999 and immediately filed a motion to sell their assets to Akrion in accordance with the terms of the sale agreement. The United States District Court for the District of Delaware withdrew the reference of the bankruptcy case to the United States Bankruptcy Court for the District of Delaware. At the hearing before the district court to approve the sale, Akrion submitted a bid of approximately $55.5 million, consisting of $10.2 million in cash to repay Greyrock's pre- and post-petition financing and to cover administrative claims, a credit bid in the amount of just over $40 million and assumption of various liabilities aggregating approximately $5.3 million. No other bids were submitted for SubMicron's assets. The district court approved the sale over the objection of the creditors' committee, which contended, among other things, that the consideration paid by Akrion was not fair and reasonable and the sale was not undertaken in good faith.

Instead of appealing the order approving the sale, the creditors' committee sued KB/Equinox and Celerity in district court seeking to recharacterize their debts as equity investments or, in the alternative, to designate those debts as unsecured — in either case invalidating the 1999 Funding as a basis for a credit bid under section 363(k). Failing either of those options, the committee (which was later succeeded in the litigation by the plan administrator for SubMicron's estate) sought to equitably subordinate the claims under section 510(c) of the Bankruptcy Code based upon fiduciary improprieties and other misconduct allegedly committed by KB/Equinox and Celerity. The district court ruled in favor of KB/Equinox and Celerity on all counts. The administrator appealed to the Third Circuit.

The Third Circuit's Ruling

The Court of Appeals affirmed. It found no error in the district court's refusal to recast the 1999 Funding as an equity investment based upon the underlying documentation and the parties' intent. According to the Third Circuit, given the previous loans made by KB/Equinox and Celerity and the lenders' legitimate desire to protect the integrity of the credit, neither SubMicron's undercapitalization at the time of the 1999 Funding nor the presence of KB/Equinox and Celerity personnel on SubMicron's board necessarily supported an equity characterization. It also accepted the district court's conclusion that the parties did not intend the undocumented portion of the funding to be treated as equity merely because apparently no notes were issued in connection with the financing transaction — the evidence clearly indicated that “SubMicron's accounting department made numerous mistakes and errors when generating notes.”

Having concluded that the 1999 Funding should be properly treated as debt, rather than equity, the Third Circuit turned to the administrator's contention that the debt should be treated as unsecured because the UCC financing statements filed in connection with the loans identified as the secured party KB's managing partner Equinox “as Collateral Agent,” rather than KB or Celerity. The Court of Appeals rejected this argument as well, ruling that the financing statements contained adequate information to comply with the UCC's perfection requirements and that SubMicron had acknowledged the status of KB and Celerity as secured noteholders in schedules that it filed in its bankruptcy case.

The Third Circuit proceeded to address the plan administrator's argument that Akrion's credit bid was invalid because KB/Equinox and Celerity were undersecured. Acknowledging that the district court had determined that “there was no collateral [value] available to actually secure the 1999 fundings,” the Court of Appeals explained that section 363(k) has uniformly been interpreted to allow a secured creditor to credit bid the face value rather than the economic value of a secured creditor's claims. According to the Third Circuit, “logic demands that § 363(k) be interpreted in this way; interpreting it to cap credit bids at the economic value of the underlying collateral is theoretically nonsensical." This is so, the Court of Appeals emphasized, because whatever amount a secured creditor credit bids under section 363(k) up to the face amount of its claim automatically becomes the economic value of the claim by operation of section 506(a).

The Third Circuit explained that the legislative history indicates that Congress meant to incorporate this degree of protection for undersecured creditors when it enacted sections 363(k) and 1111(b) of the Bankruptcy Code. It rejected the administrator's contention that there should be an exception to the rule in this case because there were no unencumbered assets available to secure the 1999 Funding when it was provided:

> Because the Lenders had a valid security interest in essentially all the assets sold, by definition they were entitled to the satisfaction of their claims from available proceeds of any sale of those underlying assets. Their credit bid did nothing more than preserve their right to the proceeds, as credit bids do under § 363(k).

The term "allowed claim" in section 363(k), the Third Circuit observed, clearly means both the secured and unsecured portions of a creditor's claim secured by a lien on property of the estate. According to the Court, reference to section 506(a) to determine the amount of a secured claim is unnecessary in the context of a sale under section 363. Section 363, the Third Circuit remarked, "attempts to avoid the complexities and inefficiencies of valuing collateral altogether by substituting the theoretically preferable mechanism of a free market sale to set the price."

Finally, the Third Circuit agreed with the district court that the plan administrator's equitable subordination argument was legally untenable. Declining to address whether creditor misconduct is a necessary prerequisite to equitable subordination of a claim under section 510(c) of the Bankruptcy Code, the Court of Appeals held that the absence of any injury or disadvantage to SubMicron's other creditors as a consequence of actions undertaken by

KB/Equinox and Celerity meant that subordination was unjustified. To the contrary, the Court noted, had the lenders not extended additional financing to the debtor, "the company would have been forced to close down and liquidate, leaving the unsecured creditors with nothing." It accordingly affirmed the ruling of the district court in all respects.

Outlook

SubMicron does not represent a departure from prior case law concerning the circumstances under which a secured creditor may credit bid its claims pursuant to section 363(k). Like section 1111(b), the provision was designed to ensure that a secured creditor can realize the maximum value from its collateral, even if the amount of the debt it secures exceeds that value at any given time during the course of the bankruptcy case. Under *SubMicron*, unless the secured creditor's liens are subject to bona fide dispute, it may credit bid the face amount of its secured claim in any sale of the collateral under section 363.

Even so, *SubMicron* is notable because it is the first federal court of appeals to render a ruling on the issue. *SubMicron* confirms the viability of credit bidding at face value even if the collateral's value is less than the secured creditor's claim. Because SubMicron's first priority lender was paid off in cash at the time of the sale, KB/Equinox and Celerity, by virtue of the 1997 Notes and the 1998 Notes, had the next priority claim to SubMicron's assets even if they were of insufficient value to act as security for the 1999 Funding. Thus, the fact that part of the credit bid consisted of unsecured debt — the creditors in this instance were undersecured — is not troubling.

SubMicron also illustrates that, when faced with a potential credit bid significantly in excess of the market value of a given asset, other bidders might be unwilling to put serious time, effort and expense into developing and pursuing a bid. Indeed, as with Akrion, potential purchasers may wish to consider teaming up with undersecured creditors to gain an advantage through credit bidding — which brings up another interesting aspect of *SubMicron*. *SubMicron* is a classic example of creditors working closely with a potential acquirer in the sale process. KB/Equinox and Celerity negotiated the acquisition from start to finish, with SubMicron's equity holders and unsecured creditors sitting in the wings and out of the money.

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