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Aéropostale Bankruptcy Court Denies Motion to Equitably Subordinate or Recharacterize Secured Lenders' Claims or to Limit Lenders' Credit Bidding Rights

By Brad B. Erens and Mark G. Douglas*

This article discusses the U.S. Bankruptcy Court for the Southern District of New York's decision in the Chapter 11 cases of Aéropostale, Inc. and its affiliates. The decision has been a welcome development for secured lenders, particularly insofar as the ruling reinforces the idea that a court-imposed limitation on a lender's right to credit bid requires something more than the possibility of bid chilling in connection with a Section 363 asset sale. However, like many other recent rulings involving allegations of lender overreaching or other misconduct, the decision is a cautionary tale. The authors explain why.

Secured lenders have welcomed a ruling recently handed down by the U.S. Bankruptcy Court for the Southern District of New York in the Chapter 11 cases of Aéropostale, Inc. and its affiliates (collectively, "Aéropostale"). In *In re Aéropostale, Inc.*,[1] bankruptcy judge Sean H. Lane denied motions by Aéropostale to: (i) equitably subordinate the secured claims of term lenders that were affiliated with a private equity sponsor; (ii) limit the lenders' ability to credit bid their secured claim in a bankruptcy sale of the company; and (iii) recharacterize the lenders' $150 million secured claim as an equity investment.

EQUITABLE SUBORDINATION

Equitable subordination is a remedy developed under common law prior to the enactment of the current Bankruptcy Code to remedy misconduct that results in injury to creditors or shareholders. It is expressly recognized in Section 510(c) of the Bankruptcy Code, which provides that the bankruptcy court may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed

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[1] 555 B.R. 369 (Bankr. S.D.N.Y. 2016).

claim or all or part of an allowed interest to all or part of another allowed interest." However, the statute explains neither the equitable subordination theory nor the standard that should be used to apply it.

In *In re Mobile Steel Co.*,[2] the U.S. Court of Appeals for the Fifth Circuit articulated what has become the most commonly accepted standard for equitable subordination of a claim. Under this standard, a claim can be subordinated if the claimant engaged in some type of inequitable conduct that resulted in injury to creditors (or conferred an unfair advantage on the claimant) and if equitable subordination of the claim is consistent with the provisions of the Bankruptcy Code. Courts have refined the test to account for special circumstances. For example, many courts make a distinction between insiders (*e.g.*, corporate fiduciaries) and non-insiders in assessing the level of misconduct necessary to warrant subordination.[3]

RECHARACTERIZATION

A related but distinct remedy is "recharacterization." Like equitable subordination, the power to treat a debt as if it were actually an equity interest is derived from principles of equity. It emanates from the bankruptcy court's power to ignore the form of a transaction and give effect to its substance. However, because the Bankruptcy Code does not expressly empower a bankruptcy court to recharacterize debt as equity, some courts disagree as to whether they have the authority to do so and, if so, the source of such authority.

Four Circuits have held that a bankruptcy court's power to recharacterize debt derives from the broad equitable powers set forth in Section 105(a) of the Bankruptcy Code, which provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]."[4]

The Fifth and Ninth Circuits have taken a different approach, holding instead that Section 502(b)(1) of the Bankruptcy Code, which provides in relevant part that "the court . . . shall allow [a] claim . . . except to the extent that . . . such claim is unenforceable against the debtor and property of the

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[2] 563 F.2d 692 (5th Cir. 1977).

[3] *See generally* Collier on Bankruptcy ¶ 510.0[2] (16th ed. 2016).

[4] *See Committee of Unsecured Creditors for Dornier Aviation (North America), Inc.*, 453 F.3d 225 (4th Cir. 2006); *Cohen v. KB Mezzanine Fund, II, LP (In re SubMicron Systems Corp.)*, 432 F.3d 448 (3d Cir. 2006); *Sender v. Bronze Group, Ltd. (In re Hedged-Invs. Assocs., Inc.)*, 380 F.3d 1292 (10th Cir. 2004); *Bayer Corp. v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.)*, 269 F.3d 726 (6th Cir. 2001).

debtor, under any agreement or applicable law," is the proper statutory authority for recharacterization.[5]

In some jurisdictions that recognize the doctrine of recharacterization, uncertainty exists regarding the legal standard for determining when recharacterization is appropriate. In *AutoStyle Plastics*, the U.S. Court of Appeals for the Sixth Circuit applied an 11-factor test derived from federal tax law. Among the enumerated factors are:

- the labels given to the alleged debt;
- the presence or absence of a fixed maturity date, interest rate, and schedule of payments;
- whether the borrower is adequately capitalized;
- any identity of interest between the creditor and the stockholder;
- whether the loan is secured; and
- the corporation's ability to obtain financing from outside lending institutions.[6]

Under this test, no single factor is controlling. Instead, each factor is to be considered in the particular circumstances of the case.

CREDIT BIDDING

Section 363(k) of the Bankruptcy Code provides that a creditor with a lien on assets to be sold outside the ordinary course of business under Section 363(b) may credit bid its "allowed claim" at the sale, "unless the court for cause orders otherwise." A credit bid is an offset of a secured claim against the collateral's purchase price. The U.S. Supreme Court explained in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*[7] that "[t]he ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price" and "[i]t enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan."

The Supreme Court ruled in *RadLAX* that, although the right to credit bid is not absolute, a nonconsensual, or "cram down," Chapter 11 plan providing

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[5] *See Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.),* 650 F.3d 539 (5th Cir. 2011); *Official Comm. of Unsecured Creditors v. Hancock Park Capital II, L.P. (In re Fitness Holdings Int'l, Inc.)*, 714 F.3d 1141 (9th Cir. 2013).

[6] *See also Hedged-Investments*, 380 F.3d at 1298 (applying similar 13-factor test).

[7] 132 S. Ct. 2065, 2070 n.2 (2012).

for the sale of encumbered property free and clear of a creditor's lien cannot be confirmed without affording the creditor the right to credit bid for the property.

In the aftermath of *RadLAX*, the debate shifted largely to the circumstances that constitute "cause" under Section 363(k) to prohibit or limit a secured creditor's right to credit bid its claim. The term "cause" is not defined in the Bankruptcy Code, leaving it to the courts to determine whether cause exists on a case-by-case basis.[8]

In *In re Fisker Automotive Holdings, Inc.*,[9] the court limited the amount of a credit bid to the discounted purchase price actually paid by the credit bidder to purchase a debt. The court held that limiting the amount of the credit bid was warranted because an unrestricted credit bid would chill bidding and because the full scope of the underlying lien was as yet undetermined. The court also expressed concern as to the expedited nature of the proposed sale under Section 363(b), which in the court's view was never satisfactorily explained. After *Fisker*, a handful of courts have addressed the issue, with mixed results.[10]

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[8] *See In re Olde Prairie Block Owner, LLC*, 464 B.R. 337 (Bankr. N.D. Ill. 2011) (citations omitted).

[9] 510 B.R. 55 (Bankr. D. Del. 2014), *leave to app. denied*, 2014 U.S. Dist. LEXIS 15497 (D. Del. Feb. 7, 2014), *certification denied*, 2014 U.S. Dist. LEXIS 17689 (D. Del. Feb. 12, 2014).

[10] *See, e.g.*, *SEC v. Capital Cove Bancorp LLC*, 2015 U.S. Dist. LEXIS 174856 (C.D. Cal. Oct. 13, 2015) (finding "cause" to deny a creditor's request to credit bid at a sale due to, among other things, the existence of a prima facie case against the creditor for securities fraud, evidence of a Ponzi scheme involving the creditor, the creditor's other fraudulent acts and the existence of a bona fide dispute regarding the validity of the creditor's liens); *In re Family Christian, LLC*, 533 B.R. 600 (Bankr. W.D. Mich. 2015) (refusing to approve a credit-bid sale to a party that had been privy to certain information as a "consultation party" to the auction that allowed it to gain an unfair advantage over other bidders tantamount to insider trading); *In re The Free Lance-Star Publishing Co.*, 512 B.R. 798 (Bankr. E.D. Va.) (finding "cause" to limit a credit bid by an entity that purchased $39 million in face amount of debt at a discount where: (i) some of the creditor's liens had been improperly perfected; (ii) the creditor engaged in inequitable conduct by forcing the debtor into bankruptcy and an expedited section 363 sale process in pursuing a clearly identified loan-to-own strategy; and (iii) the creditor actively frustrated the competitive bidding process and attempted to depress the sale price of the debtors' assets), *leave to appeal denied sub nom. DSP Acquisition, LLC v. Free Lance-Star Publishing Co.*, 512 B.R. 808 (E.D. Va. 2014); *In re Charles Street African Methodist Episcopal Church of Boston*, 510 B.R. 453 (Bankr. D. Mass. 2014) (denying in part a motion to limit a credit bid where the debtor's counterclaims did not relate to the validity of the secured creditor's claims or liens, but requiring the secured creditor to include in its bid cash in an amount equal to a breakup fee payable to the stalking horse bidder); *In re RML Dev., Inc.*, 528 B.R. 150 (Bankr. W.D. Tenn. 2014) (limiting a secured creditor's credit bid to the undisputed portion of its claim).

AÉROPOSTALE

Aéropostale, Inc. ("Aéropostale") is a retailer of child and young adult casual apparel and accessories with more than 800 stores in all 50 states and Puerto Rico. In 2013, private equity firm Sycamore Partners ("Sycamore") acquired eight percent of Aéropostale stock through a subsidiary for approximately $54 million.

One of Aéropostale's largest merchandise suppliers was TSAM (Delaware) LLC (d/b/a MGF Sourcing US LLC) ("MGF"), a global apparel and accessory sourcing company indirectly owned and controlled by Sycamore.

Aéropostale's secured debt included a $150 million term loan extended by two Sycamore affiliates (collectively, the "term lenders"). An investor rights agreement entered into in connection with the term loan gave a term lender the right to nominate two directors to Aéropostale's board and to select a third independent director jointly with Aéropostale. The term loan contained a $70 million minimum liquidity covenant. A separate sourcing agreement between Aéropostale and MGF gave MGF the right to declare a "credit review period" if Aéropostale's liquidity dropped below $150 million.

In February 2016, MGF informed Aéropostale that the $150 million minimum liquidity threshold under the sourcing agreement had been breached and that MGF was declaring a credit review period. MGF also informed Aéropostale that it was adjusting the payment terms for sourced merchandise, as was permitted by the sourcing agreement.

Aéropostale commenced a Chapter 11 case on May 4, 2016, in the Southern District of New York with a plan to shutter unprofitable stores, trim costs and pursue a sale of the company.

Claiming that Sycamore forced the company into bankruptcy for the purpose of acquiring it at a discount, Aéropostale filed a motion requesting that the court: (i) equitably subordinate the claims of the term lenders under Section 510(c) of the Bankruptcy Code due to their inequitable conduct (*e.g.*, imposing new lending terms that violated an "objective reasonableness" standard, pursuing a secret and improper plan to buy Aéropostale "on the cheap," and trading Aéropostale's stock while possessing material non-public information); (ii) limit the term lenders' right to credit bid their $150 million secured claim in any sale of the company pursuant to Section 363(k) of the Bankruptcy Code; and (iii) recharacterize the term lenders' claims as equity under Section 105 of the Bankruptcy Code.

THE BANKRUPTCY COURT'S RULING

No Equitable Subordination

Bankruptcy judge Sean Lane denied the motion to equitably subordinate the term lenders' claims. First, he noted that Aéropostale did not dispute that it fell below the $150 million minimum liquidity trigger, causing MGF to declare a credit review period and later impose new credit terms. Judge Lane agreed that MGF was limited in its ability to alter payment terms under the sourcing agreement, but found that Aéropostale was attempting to impose an "objective reasonableness" standard on MGF that was not present in the language of the agreement. Instead, he noted, under the express terms of the sourcing agreement, "MGF had the right to apply *its* reasonable credit judgment in light of *its* determination of what was prudent for *it*."

Judge Lane also found that MGF acted reasonably in imposing new credit terms after the minimum liquidity threshold was triggered. Among other things, the evidence showed that MGF faced significant exposure itself—an Aéropostale default could have caused MGF to default on its own debt.

In addition, Judge Lane wrote that, "simply put," Aéropostale's "allegation of a secret plan" to "push [the company] into bankruptcy and thus buy Aéropostale on the cheap" is "not credible." He explained that, although Sycamore and its affiliates "actively tracked and managed" their investment in Aéropostale, which consisted of $54 million in equity and a $150 million loan, it was easy to understand why they were closely monitoring Aéropostale's situation, given the company's lackluster performance and their large economic stake. Judge Lane also noted that there was no credible evidence that Sycamore caused MGF to take any improper action in connection with the sourcing agreement or the invocation of a credit review period. He explained that:

> 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. Instead, the totality of the credible evidence at trial demonstrates that [Sycamore and its affiliates] did not take actions beyond what was proper to protect their interests.

According to Judge Lane, Aéropostale's allegations that Sycamore traded Aéropostale stock while in possession of material non-public information was belied by evidence that the stock price actually decreased during the relevant period. Moreover, the allegations failed to support a claim for equitable subordination because there was no evidence that Aéropostale was harmed or

that Sycamore gained any unfair advantage.

No Cause to Limit Credit Bid

Judge Lane also denied Aéropostale's motion to limit the term lenders' right to credit bid their $150 million secured claim. Explaining that "[t]he decision of whether to deny credit bidding based on cause [under Section 363(k) of the Bankruptcy Code] is within the discretion of the court," he found no inequitable conduct that would justify limiting a credit bid by the term lenders. According to Judge Lane, there was no evidence of inappropriate behavior by the term lenders in connection with the bankruptcy case, such as "allegations of collusion, undisclosed agreements, or any other actions designed to chill the bidding or unfairly distort the sale process." In fact, he noted, "consistent with the exercise of their own legal rights," the term lenders were relatively cooperative with the bidding and sale process, and no party challenged the validity or extent of their liens.

Judge Lane rejected Aéropostale's argument that bidding on the sale of its assets would be chilled by the term lenders. First, he noted, none of the cases commonly cited as a basis for limiting a credit bid has involved bid chilling as the sole factor warranting such a limitation. Instead, he explained, rulings such as *Free Lance-Star, Fisker*, *Aloha Airlines,* and similar cases have involved other factors as well, such as a dispute regarding the validity of the secured creditor's lien or inequitable conduct. Moreover, he noted, the record reflected an active interest in Aéropostale assets rather than chilled bidding.

Finally, Judge Lane explained that his reasoning is supported by the final report issued on December 8, 2014, by the American Bankruptcy Institute Commission to Study the Reform of Chapter 11. In its report, the ABI Commission notes that "all credit bidding chills an auction process to some extent" and that, as a consequence, "the Commissioners did not believe that the chilling effect of credit bids alone should suffice as cause under section 363(k)."

No Basis to Recharacterize Debt as Equity

Judge Lane ruled that there was no basis to recharacterize the term loan as an equity investment in Aéropostale. "Based on the *AutoStyle* factors and the surrounding facts and circumstances," he wrote, "the Court finds that the parties intended the [term loan facility] to be a loan."

OUTLOOK

Aéropostale has been a welcome development for secured lenders, particularly insofar as the ruling reinforces the idea that a court-imposed limitation on a lender's right to credit bid requires something more than the possibility of bid

chilling in connection with a Section 363 asset sale. However, like many other recent rulings involving allegations of lender overreaching or other misconduct, the decision is a cautionary tale. A variety of tools are available in bankruptcy to remedy creditor misconduct or overreaching. In addition to equitably subordinating a claim, recharacterizing a debt as equity or limiting a secured creditor's right to credit bid, a bankruptcy court can "designate," or not count, a creditor's vote on a Chapter 11 plan if it determines that the vote was cast in bad faith.

Aéropostale's stated fears that the term lenders' right to credit bid their secured claim would chill bidding were ultimately unfounded. On September 13, 2016, Judge Lane approved an auction sale of Aéropostale's assets for $243.3 million to a consortium of mall owners including retail property management firm General Growth Properties and apparel brand licensor Authentic Brands Group. The sale saved 229 of the teen apparel retailer's stores and prevented a complete liquidation that would have left hundreds of vacant stores in malls throughout the United States.