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Majority Rules: Impact of Bankruptcy 'Credit Bid' Rulings

Law360, New York (November 09, 2009) -- Restructuring the obligations of a distressed borrower is a process that requires compromise and consensus building. The larger the constituency needed to reach a deal, the greater the risk of holdouts erecting barriers to a consensual workout arrangement.

Courts have sought to mitigate this problem by inferring an “inten[t] to act collectively in the event of the borrower’s default”[1] when interpreting loan documents.

The most notable recent example of this approach was the Second Circuit’s holding in In re Chrysler LLC,[2] where the court affirmed the approval of a “free-and-clear” sale pursuant to section 363 of the Bankruptcy Code over the objection of a group of minority lenders.

Three recent cases, In re GWLS Holdings,[3] In re Metaldyne Corporation[4] and In re Electroglas Inc.,[5] have illustrated that courts will apply this collective action model of contract interpretation in the credit bidding context.

These cases suggest that, when courts are faced with dissenting lenders and loan documents that are otherwise silent on the issue, courts will favor a reading that imposes collective action on the lender group.

Credit Bidding

Section 363(k) of the Bankruptcy Code permits the holder of a lien securing an allowed claim to bid up to the entire amount of such claim at the sale of the assets of a debtor-in-possession out of the ordinary course of business.

The lienholder may offset its claim against the purchase price of the assets, rather than paying cash. Disputes arise when some members of the secured lender group attempt to “opt out” of the majority direction to credit bid or otherwise oppose the credit bid.

Collective Action Analysis

The inference of a collective action requirement in loan documents first arose in the context of settlements.

Beal Savings Bank v. Sommer[6] and In re Delta Airlines Inc.[7] both addressed settlements between lenders and obligors that were approved by the majority of lenders despite minority objections.

The courts in these cases set out an analytical framework that courts continue to follow in addressing collective action issues under loan documents.

In both cases, the court concluded that the loan documents intended for the lenders to act collectively through an agent or trustee, and that individual lenders could be prohibited from settling their own disputes and be bound by the will of the majority.

These cases both noted that the loan documents granted broad authority to the agent or trustee in the event of a borrower default — to be exercised at the direction of a majority (or supermajority) of the lenders — but did not confer such authority on individual lenders.

Although the loan documents did not address settlements specifically, the Beal and Delta courts concluded that the agent or trustee could bind all lenders under a majority lender-approved settlement agreement once the borrower was in default.

“Implicit in the authority to commence proceedings to remedy defaults is the power to negotiate and agree upon settlements, subject to the power to direct in writing by a majority in amount of the bondholders.”[8]

While the loan documents did not provide for such authority explicitly, the court in Beal found “an unequivocal collective design.”[9]

In both cases, the court had to address provisions in the loan documents that appeared to impose unanimous voting requirements on certain terms of the settlements at issue.

In Beal, the settlement released a guarantor from its obligations under the loan documents, despite a provision in the loan documents prohibiting any amendment or waiver that released the guarantor without the consent of all lenders.

In Delta, the settlement contemplated a reduced recovery for bondholders despite “‘nonimpairment provisions’ ... preclud[ing] any impairment of bondholders’ rights under the indenture,”[10] without the consent of the bondholders.

In both cases, the courts found that the settlement terms at issue were outside the scope of these provisions.

The Beal court concluded that a settlement was not equivalent to an amendment or waiver and that the amendment provision did not preclude the agent from settling an action it was otherwise entitled to pursue in the event of a default.

The court in Delta took the view that impairment of the bondholders' interests was an inevitability under the Bankruptcy Code, rendering the nonimpairment provisions moot.

These cases establish a two-step analysis that continues to be employed in collective action cases:

— The authority granted to the agent or trustee to act on behalf of the lenders in the event of a default (generally at the direction of a majority of the lenders) is read broadly to allow a majority-lender direction to bind all lenders in a variety of contexts, and

— Provisions imposing unanimous voting requirements in respect of amendments, waivers and other similar actions are read narrowly.

The Second Circuit's decision in Chrysler was an important development in this line of cases, both in terms of it being a very high-profile case and a circuit court-level opinion, which carries greater precedential weight than a district or bankruptcy court decision.

The court considered whether the consent requirement under section 363(f)(2) of the Bankruptcy Code could be satisfied by a majority vote of the secured lenders over the objection of a group of minority lenders.

As in Beal and Delta, the court concluded that the administrative agent was authorized to act on behalf of all lenders at the direction of a majority and that the unanimous vote requirement of the amendment and waiver provision was inapplicable, because no amendment or waiver was being sought.[11]

Credit Bidding Cases

The collective action analysis established in the cases described above has been applied in several recent credit bidding cases.

In In re GWLS Holdings,[12] which preceded Chrysler, the bankruptcy court considered whether a credit bid could proceed over the objection of a dissenting secured lender.

Grace Bay Holdings II LLC argued that the credit bid was an impermissible release of the lien on the collateral without unanimous consent. The court followed the analysis laid out in prior collective action cases.

First, it characterized the release of the lien as being within the scope of the agent's authority in an event of default.

The first lien secured lenders had irrevocably appointed the first lien collateral agent to "take such actions on [their] behalf and to exercise such powers as are delegated ... by the terms hereof,"[13] which included the power to dispose of collateral upon an event of default.

Next, the court determined that the unanimous voting requirements applicable to amendments or waivers that release collateral did not apply in the context of a credit bid.

Instead, the court held that credit bidding fell within the agent's delegated powers to "dispose of or deliver the collateral" on behalf of the secured parties pursuant to any applicable law, which the court determined included the Bankruptcy Code.[14]

In Metaldyne, two private equity sponsors teamed up with the secured lenders to make an offer consisting of a credit bid of all the senior secured debt, cash and the assumption of certain liabilities, for substantially all of the assets of the company.

Approximately 97 percent of the secured lenders approved the transaction. BDC Finance LLC, a single lender holding less than 1 percent of the secured debt, argued that its portion of the secured debt could not be credit bid over its objection.

The court followed a virtually identical analysis to that set forth in GWLS, relying on similar provisions under Metaldyne's loan documents to conclude that the agent had been granted authority to release the collateral in the event of a default and that the amendment and waiver provision was inapplicable because "the sale through a credit bid does not involve or require amendment or modification of the loan documents."[15]

An additional objection that BDC raised highlights an interesting issue for credit bids in the context of a syndicated loan facility or a secured bond indenture.

A credit bid for substantially all the assets of a debtor is essentially a debt-for-equity exchange, and the case law holds that a credit bid may be made over the objection of a dissenting lender.

However, it is one thing for a lender to be bound by a "free and clear" consent like in Chrysler when the lender is to receive cash in connection with the sale; it is quite a different proposition for a lender to be forced to take back equity in a "Newco" purchaser of assets in a credit bid.

BDC argued that it should not be forced take equity without knowing the corporate structure of the new entity or the precise nature of the equity consideration it would receive as its distribution.

The court did not address this issue as it viewed the matter as an intercreditor dispute not properly before it as a bankruptcy court.

Rather, it preserved BDC's claims against the new entity, noting that "nothing in the sale order dictates how proceeds from or equity in the purchased assets should be shared among the lenders."[16]

However, this issue highlights a complexity that must be addressed when lenders take back equity in a credit bid, as equity ownership raises a whole host of potentially complex issues, such as corporate governance and control over the Newco purchaser, limitations that certain lenders may have in terms of holding equity (e.g., a CLO lender whose "equity basket" is full) and, in a regulated industry (such as the gaming and media industries), licensing requirements or foreign ownership restrictions. In fact, BDC continues to argue this point on appeal.

In In re Electroglas Inc., the court took the collective action approach one step further. The case involved competing credit bids — one by minority holders who sought the ability to credit bid just their secured notes, and another by the majority holders who sought to credit bid all the notes.

The court held that noteholders may not credit bid directly either their portion of the notes or all the notes; rather, only the indenture trustee could credit bid.

Like in the earlier collective action cases, the court appeared to be motivated at least in part by a desire to avoid the confusion and disruption that may be caused by allowing individual lender action, as opposed to having all enforcement actions funneled through a single agent.

This part of the case appears to have been correctly decided. However, the court went on to find that even a majority of the noteholders could not force the trustee to take a specific substantive action, such as credit bidding.

Given that the trustee typically has no independent economic interest (and is typically fully indemnified and exculpated in respect of any action taken at the direction of the requisite majority of noteholders), this is a surprising result.

Future Considerations

The decisions in the credit bidding cases above suggest that where secured lenders delegate the power to exercise remedies to a collateral agent or trustee, an objecting secured creditor will be prohibited from settling its claim independently and instead will be forced to follow the will of the majority.

While these decisions were all based on agent authorization language in credit documents that is quite customary, it is interesting to note that such provisions typically do not expressly deal with credit bidding.

That may change — either to affirmatively permit it at the direction of a majority in interest of the lenders (i.e., to expressly provide by contract what the cases have held), or, in light of the issues relating to lenders taking back equity, by attempting to deal with those complexities, such as by specifying the corporate governance structure of any Newco credit bid purchaser or addressing other equity ownership issues.

Dealing with all of this upfront may be too tall an order for the credit documentation, but it is certainly worth lenders and their counsel thinking through what changes should be made in loan documents to make sure they reflect the intent of all parties in respect of these important issues.

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[1] Beal Sav. Bank v. Sommer, 8 N.Y.3d 318, 321 (2007).

[2] 576 F.3d 108 (2d Cir. 2009).

[3] No. 08-12430(PJW), 2009 WL 453110 (Bankr. D. Del. Feb. 23, 2009).

[4] 409 B.R. 671 (Bankr. S.D.N.Y. 2009).

[5] Case No. 09-12416 (PJW) (Bankr. D. Del. Sep. 23, 2009).

[6] 8 N.Y.3d 318, 321 (2007).

[7] 370 B.R. 537 (Bankr. S.D.N.Y. 2007).

[8] Id. at 548.

[9] 8 N.Y.3d at 326.

[10] 370 B.R. at 546.

[11] 200 U.S. App. LEXIS 17411, at *31.

[12] No. 08-12430(PJW), 2009 WL 453110 (Bankr. D. Del. Feb. 23, 2009).

[13] 2009 WL 453110, at *3

[14] Id. at *5.

[15] 409 B.R. at 678.

[16] Id. at 679.