New York Law Journal
Corporate Update
WWW.NYLJ.COM
An ALM Publication
VOLUME 256—NO. 68
THURSDAY, OCTOBER 6, 2016

SECURED TRANSACTIONS

# When Can't a Creditor Credit Bid?

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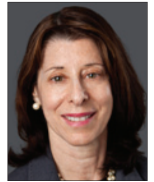

The growing presence of non-traditional lenders has been a noticeable trend in the finance industry for years. Yet these lenders have always played a prominent role in distressed lending. Oftentimes they are industry participants who are not only extending a lifeline to the debtor but perhaps more importantly protecting their customer base.

Because of their multiple relationships, these lenders also typically find themselves entangled with the debtor in more ways than just debt financing. And these relationships are not without risk. Other creditors are more than happy to try to convince a bankruptcy judge that a creditor with equity or mercantile connections to a debtor deserves less favorable treatment. Bankruptcy courts are courts of equity. They can impose restraints on a creditor by limiting its right to credit bid, or, even worse, subordinating its claims.

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Such was the focus of a recent decision in the Southern District of New York by Bankruptcy Judge Sean Lane in the *Aéropostale* case.[1]

## Factual Background

The debtors in the Aéropostale bankruptcy, all subsidiaries of Aéropostale, a publicly-traded company, were retailers of casual apparel and accessories, and a ubiquitous presence in retail shopping malls. At the end of 2015, they operated 811 stores in the United States and 41 stores in Canada. The debtors designed their merchandise and contracted out the manufacturing to others.

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In mid to late 2013, Sycamore Partners, a private equity firm with a focus on retail and consumer investments, acquired through open market purchases approximately 8 percent of the outstanding shares of Aéropostale. Sycamore also owned an indirect majority interest in TSAM (Delaware) LLC (d/b/a/MGF Sourcing US LLC) (MGF), a global contracting company that acts as intermediary between apparel manufacturers and retailers, with a presence in over 13 countries and a 40-plus year history in business.

Aéropostale began to experience financial difficulty, and by the end of fiscal year 2013 had negative EBITDA of over $70 million. In early 2014, Aéropostale and Sycamore commenced discussions on possible financing arrangements. After several months, they settled on a $150 million term loan financing that consisted of a $100 million bullet tranche A term loan from an investment vehicle formed by Sycamore affiliates and a $50 million tranche B term loan funded by the parent of MGF. The arrangement also required entering into a "sourcing" agreement with MGF that imposed minimum volume purchasing requirements on the debtors. As a result of that

arrangement, MGF became one of the two largest suppliers to Aéropostale (the other being LF Sourcing Millwork LLC (Li & Fung)). Additionally, Aéropostale issued preferred stock to affiliates of Sycamore convertible into another 5 percent of the outstanding common stock.

The term loan agreement and the sourcing agreement both imposed minimum liquidity requirements on the debtors—$70 million in the case of the term loan agreement and $150 million in the case of the sourcing agreement. Failure to comply with the liquidity requirement under the sourcing agreement would allow MGF to alter the payment terms.

The term loan agreement required detailed monthly and quarterly financial reporting subject to a confidentiality requirement, although information could be shared with affiliates. The tranche A lender had the right to nominate directors to the Aéropostale parent board.

In February 2016, Sycamore's affiliate sold the entirety of its equity investment in Aéropostale for a substantial loss and MGF changed its payment terms from net 30 days to require cash in advance or a letter of credit. Aéropostale filed for bankruptcy in May 2016.

## Analysis—Chilling Credit Bids

Once in bankruptcy, the debtors commenced a process to sell substantially all of their assets under Bankruptcy Code §363. At the same time they launched a multi-prong attack under the Bankruptcy Code on the Sycamore term loan lenders, arguing that their claims should be equitably subordinated pursuant to §510(c) and recharacterized as equity pursuant to §105, and that even if the court disagreed with the first two challenges, such lenders be disqualified from credit bidding under §363(k).[2] The basis for these assertions was inequitable conduct as well as, in the case of credit bidding, the effect of a credit bid by such lenders. The court flatly rejected all of these arguments.

> The court in 'Aéropostale' emphasized that all credit bids chill the bidding process somewhat.

Credit bidding permits a secured creditor to bid for and purchase its collateral using the debtor's outstanding debt as payment. But there is no unconditional right to credit bid. Under Bankruptcy Code §363(k), a party may credit bid "unless the court for cause orders otherwise." "Cause" is not defined and courts are left to fashion their own standards and requirements. Judges have limited or withdrawn the right to credit bid when the secured creditor's lien is subject to question, it has engaged in inequitable conduct, or allowing it to do so would unacceptably "chill" the bidding process.[3]

The *Aéropostale* court began its analysis by noting that no creditor had questioned the Sycamore entity liens. It then turned to the allegations of inequitable conduct.

In support of their assertion that the Sycamore term lenders be both equitably subordinated and prohibited from credit bidding, the debtors claimed that MGF improperly changed the payment terms of the sourcing agreement, that the Sycamore parties' conduct was part of a "secret and improper plan" to take over Aéropostale, and that the Sycamore parties disposed of their Aéropostale public stock in reliance on material non-public information.[4]

The court dismissed these arguments, first, in the context of equitable subordination. It disagreed that the payment terms were changed in violation of the contract, finding that MGF had the right to, and did, apply its reasonable credit judgment as required by the contract in changing such terms, and further, that UCC §2-609(1) gives a vendor the right to adequate assurance of payment even without the benefit of contractual rights. It held the allegations of a "secret" takeover plan simply not credible. Finally, it ruled that the type of harm relevant to an equitable subordination analysis was an unfair advantage to one creditor or injury to others, not impairment of marketplace integrity as a result of insider trading.

The debtors relied on the same allegations of inequitable conduct in challenging the term lenders' right to credit bid; the court found

them unsupportable for the same reasons.

The court then examined whether allowing the credit bid would "chill" the bidding process. Most notably, the court stated that it was not aware of any cases where mere chilling of bidding alone would be sufficient to limit a credit bid.[5] In so stating, it distinguished a recent controversial Delaware bankruptcy decision—*In re Fisker Automotive Holdings*.[6]

In *Fisker*, the court found more a freezing than a chilling of the bidding process—namely, that if the secured creditor was permitted to credit bid, no one else would participate. *Fisker* also cited instances of improper conduct, such as a "hurried" sale process that was "inconsistent with the notions of fairness in the bankruptcy process."[7] And rather than prohibit the credit bidding altogether, the *Fisker* court limited the bid to the creditor's purchase price for its secured claim.

The *Aéropostale* court stated that inequitable conduct was not a prerequisite to interfering with a credit bid right, and that courts may do so to promote a more competitive bidding process. The court cited with approval authority for the view that a lender may be denied the right to credit bid solely to ensure the success of a reorganization.[8]

Here, the court failed to find either inequitable conduct[9] or that the bidding process would be unacceptably "chilled" by allowing the credit bid.

## Conclusion

What are the notable takeaways from this decision? *First*, the court emphasized that the Sycamore term lenders' conduct after it became aware of the financial distress of Aéropostale was largely consistent with that of Li & Fung, the other major supplier to Aéropostale. Li & Fung was not alleged to have any relationship with Aéropostale beyond its sourcing contract. The important underlying theme: The Sycamore lenders did not take actions beyond what was proper for third parties in order to protect their interests.[10]

*Second*, the court emphasized that all credit bids chill the bidding process somewhat.[11] What it found significant was the ability of the Sycamore lenders to show an active interest in the bidding process from other parties. It was also clearly reinforced by finding that the Sycamore lenders had been "relatively cooperative" in the process, distinguishing that from the time-constrained process imposed by the debtors and the bidding creditor in *Fisker*.[12]

*Third*, the court felt that the Sycamore parties' multiple roles in their relationship with Aéropostale in and of itself was an insufficient basis for relief.[13] (Interestingly, the court did not view the Sycamore parties as insiders.[14])

As a postscript, the Aéropostale auction took place on Sept. 2, 2016. A group led by mall landlords Simon Property Group and General Growth Properties prevailed with a $243 million bid, a substantial margin above the Sycamore term loan lenders backup liquidation bid, and a plan to keep at least 229 stores open.

1. *In re Aéropostale*. No. 16-11275, 2016 WL 4506712 (Bankr. S.D.N.Y.) Aug. 26, 2016) (*Aéropostale*)
2. A full discussion of the equitable subordination and recharacterization claims is unfortunately beyond the scope of this article.
3. *Aéropostale* at *33-34.
4. Id. at *21
5. Id. at *34.
6. *In re Fisker Auto. Holdings*, 510 B.R. 55 (Bankr. D. Del. 2014).
7. Id. at 60-61.
8. *Aéropostale* at *34 n.31.
9. The court also distinguished the 2014 decision of a Virginia bankruptcy court, *In re Free Lance-Star Pub. Co.* (512 B.R. 798 (Bankr. E.D.. Va. 2014), in which the court limited a creditor's credit bid citing various instances of inequitable conduct and the negative effect of such conduct on the bidding process.
10. *Aéropostale* at 24.
11. The court cited here the findings of the American Bankruptcy Institute Commission to Study the Reform of Chapter 11, 2012-2014 Final Report 147, http://commission.abi.org/full-report.
12. *Aéropostale* at *34.
13. Id. at *28.
14. Id.

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