Loan to Own Transactions

A Practical Guidance® Practice Note by
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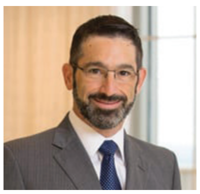

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This practice note addresses loan to own transactions. A loan to own transaction is fundamentally an acquisition strategy wherein a lender (referred to herein as an Acquisition Lender) acquires a company through the conversion of debt into equity or ownership of assets.

A loan to own transaction typically arises in one of two scenarios. First, an Acquisition Lender enters into a new secured loan with a highly leveraged company while simultaneously taking an equity interest in the borrower. Alternatively, an Acquisition Lender purchases (post-origination) a controlling tranche of existing debt (usually at a discount from face value) in anticipation of the borrower's default so that the Acquisition Lender may subsequently bid the face amount of the debt, in the event of a UCC foreclosure or bankruptcy sale, thereby allowing the Acquisition Lender to enhance its buying power vis-à-vis other bids, with a goal of owning the borrower's assets. Depending on the context, various stakeholders (e.g., unsecured creditors and shareholders) will assert different theories challenging the legality of the loan to own transaction where these constituents are or anticipate being out of the money.

In a bankruptcy setting, Acquisition Lenders use a loan to own strategy to acquire ownership of the debtor or its assets either through a plan of reorganization or an asset sale (colloquially referred to as a 363 Sale). A common goal of the Acquisition Lender—a strategic purchaser such as private equity shops and hedge funds—at least in Chapter 11 cases, is to gain ownership of the debtor's assets by converting debt into equity in the debtor or using the debtor to purchase material assets. To accomplish this goal, the Acquisition Lender possesses or acquires a sufficient number and amount of claims in a particular class of claims (typically secured claims) in order to propose or advocate for a plan of reorganization that results in their owning the assets of or equity in the reorganized debtor. These loan to own claims purchasers are less concerned about the distribution of cash recovery on account of the claims because the purchasers anticipate greater returns through owning the reorganized debtor upon its emergence from bankruptcy.

In addition, especially with the increase of nonbank lenders, it is not uncommon for an Acquisition Lender to use DIP loans as bridge financing to facilitate its acquisition of the debtor's assets. A debtor might consent to an Acquisition Lender making a DIP loan where the debtor plans on a sale of all assets and where the debtor requires DIP financing in order to effectuate the sale (i.e., a bridge loan). Under those circumstances, one of the parties interested in purchasing the assets might decide to provide the DIP loan with a view toward credit bidding at the sale, thus creating a loan to own scenario, but one that is disclosed and subject to the approval of the bankruptcy court.

In an out-of-court setting, the Acquisition Lender may purchase a controlling tranche of existing debt and use its position to effectuate a change of control transaction.

This practice note discusses loan to own transactions as follows:

- What Is a Loan to Own Transaction?
- The Concept Behind Loan to Own Transactions
- Typical Sequence of a Loan to Own Transaction
- Potential Attacks on Loan to Own Transactions
- Lack of Competitive Bidding
- Bona Fide Dispute as to the Secured Creditor's Claim
- Breach of Fiduciary Duty
- Equitable Subordination
- Alternatives and Valuation
- Good Faith
- Recharacterization

For related information and resources, see Claims Trading Benefits and Risks, Market Trends 2021: Credit Bidding, DIP Loans and Documentation, and Private Equity in Bankruptcy Resource Kit.

What Is a Loan to Own Transaction?

In broad terms, a loan to own transaction occurs when an Acquisition Lender (usually a private equity, hedge fund, or distressed debt investor) makes a secured loan with the prospect that such lender may ultimately obtain ownership of the borrower if it experiences distress. If the loan to own strategy is implemented at origination, the Acquisition Lender typically makes a secured loan and then simultaneously takes an equity stake in the borrower. The loan is evidenced through typical secured loan documentation and often includes board membership and equity-related rights. A loan to own transaction can also occur, post-origination, when the Acquisition Lender purchases debt, including a controlling position of an existing credit facility, with an eye toward bidding the face value of the debt in a potential or actual sale context.

A loan to own transaction usually occurs when a target company is, or is expected to be, highly leveraged, experiencing financial distress, or is considering undergoing a refinancing or filing for bankruptcy. The main goal of an Acquisition Lender is to use the value of the secured debt that it has obtained to gain control over the distressed company during the course of the bankruptcy or refinancing process. If the Acquisition Lender pursues the strategy post-origination, the Acquisition Lender typically seeks to acquire the secured debt of the borrower at a deep discount to enhance its leverage and return.

More and more frequently, filing for bankruptcy has become a mechanism for a quick sale under Section 363 of the Bankruptcy Code wherein the assets are sold outside of the ordinary course of business rather than through a time-consuming negotiated reorganization. For information on Section 363 sales, see Conducting Section 363 Sales, Selling Assets and Assigning Contracts and Leases in a Section 363 Sale, and Section 363 Sale Procedures, Hearings, Orders, and Appeals. Significant shortfalls between secured debt and the market value of collateral, as well as a limited pool of buyers with the requisite cash or financing to bid, has made it quite common for secured creditors to successfully credit bid on their collateral. Section 363(k) of the Bankruptcy Code provides that with respect to a sale outside of the ordinary course of business, a secured creditor may bid the allowed amount of its claim against the purchase price unless the court orders otherwise. Section 363(k) only permits holders of allowed claims to credit bid. A claim is considered allowed under the Bankruptcy Code if a party-in-interest has not objected.

In a loan to own transaction, the Acquisition Lender credit bids the allowed amount of the debt, ultimately converting the debt to a controlling equity stake in the company or ownership of the material assets. As a general matter, the Bankruptcy Code tends to favor secured creditors, but other parties-in-interest can challenge credit bids on various grounds (discussed in Lack of Competitive Bidding). For information on credit bidding, see Credit Bidding.

The Advantages of Loan to Own Transactions

A loan to own transaction is a common and often preferred alternative to a formal time-consuming bankruptcy case with an uncertain outcome. Specifically, compared to a formal bankruptcy filing, a loan to own transaction has several advantages, including the following:

- **Speed**. Compared to a conventional Chapter 11 filing, a loan to own strategy can be developed and implemented quickly. The required due diligence and documentation needed to sell debt is far simpler than the preparation required when a business is being acquired outright.

- **No trustee needed**. Often, a loan to own transaction alleviates the need for the appointment of a trustee to monitor the case and market the borrower's assets, thereby reducing administration fees and potentially driving the price for assets upward.
- **Tax benefits**. While the facts may differ on a case-by-case basis, many loan to own transactions carry with them substantial tax benefits.
- **Strategic value**. A loan to own transaction may improve the ultimate viability of the company, the position of creditors and recoveries on creditor claims, and the opportunities for the Acquisition Lender to acquire control of the business and direct its future.

The Concept Behind Loan to Own Transactions

Claims traders often acquire claims at a discount knowing that, over time, they will obtain a greater recovery. In a loan to own transaction, however, the claims purchaser's goal in acquiring the claim does not involve its actual return on the claim but instead is to acquire the claim (in this case secured debt) to convert such debt into equity of the debtor or into the direct ownership of material assets, and ultimately acquire ownership of the debtor or its material assets.

Obtaining an adequate amount of claims in a specific class of claims against a debtor can lead an Acquisition Lender to propose or advocate for a plan of reorganization that results in the Acquisition Lender itself owning the majority of the equity in the reorganized debtor or the debtor's material assets. These loan to own claimants do not especially care about a distribution of cash in respect of the claim. Instead, they anticipate generating returns by virtue of ultimately owning the reorganized debtor upon its emergence from bankruptcy. For information on claims trading, see Claims Trading Basics and Claims Trading Benefits and Risks.

The loan to own strategy creates an interesting dynamic. Holding a significant amount of secured debt gives the Acquisition Lender standing to participate in the bankruptcy case and substantial leverage to negotiate with the debtor and other constituencies. The Acquisition Lender normally would like the ability to convert its debt into equity of the reorganized company or acquire the debtor's material assets. However, the Acquisition Lender will likely have to engage in the same type of due diligence that any purchaser of a company would have to conduct—analyzing the historical and projected financial performance of the company, as well as understanding the company's customer base, vendor relationships, material contracts, labor and employment issues, and the retention of key management.

A potential Acquisition Lender must be prepared to execute a confidentiality agreement and, once it has obtained confidential information, must avoid the temptation to use (or be accused of using) confidential information to acquire additional claims against the debtor. Thus, the Acquisition Lender may have to first acquire debt knowing that it does not have important information and then refrain from obtaining more debt in order to effectuate its ultimate goal.

Typical Sequence of a Loan to Own Transaction

The theory behind a loan to own transaction is simple. The Acquisition Lender sees that the borrower's business is overleveraged but believes the business to be viable and worthy of an investment. The Acquisition Lender then makes the decision to invest through its participation as a secured lender. Though the Acquisition Lender may get repaid on its acquired debt, if the business continues to decline, the Acquisition Lender, in its role as a secured creditor, can seek to convert all or part of its debt to equity and take ownership over the company or use its secured debt to purchase the debtor's material assets. It is noteworthy that to ensure the continued viability of the acquired business, the Acquisition Lender may also agree to pay creditors essential to the business, pay other creditors up to the Acquisition Lender's valuation of the business (to avoid having these creditors challenge the loan to own transaction), and eliminate other out of the money creditors and equity holders. The Acquisition Lender will also often offer existing management the option to stay or will offer attractive severance packages so that these parties will support a second stage transaction that is favorable to the Acquisition Lender.

The process through which the Acquisition Lender obtains ownership through a refinancing or bankruptcy case will likely occur on a fast track in an effort to minimize costs, delay, opposition, and competition. If the Acquisition Lender does not get the support that it seeks, it can use the threat of foreclosure as leverage, which will leave all other constituents with pennies on the dollar, if that. Counsel should note that while the Acquisition Lender is basically in full control of the process at this point, as the holder of the economic purse-strings, the Acquisition Lender nonetheless lacks and/or should not exercise any voting control. Though the lack of voting control means that the Acquisition Lender does not sign off on loan approvals or other critical board decisions, by not exercising voting control, the Acquisition

Lender can often protect itself from claims that it is a controlling shareholder.

Loan to own transactions vary based on the nature of the specific transaction. While the terms of a loan to own transaction will change based on the financial circumstances of the Acquisition Lender and the target company, most loan to own strategies follow a similar course of events. This sequence of events typically includes the following:

- **Confidentiality agreement**. The proposed Acquisition Lender will be required to enter into a confidentiality agreement. Insisting on a confidentiality agreement is standard procedure in a loan to own scenario. The Acquisition Lender should examine the agreement to determine the precise scope of the confidential information and should confirm that the agreement does not contain any unusual or overreaching provisions such as a noncompete clause, non-solicitation requirement, indemnification provisions, or any other restrictive terms for the benefit of the secured lender.
- **Due diligence**. Following the execution of the confidentiality agreement, the Acquisition Lender will conduct due diligence with respect to the proposed transaction. The due diligence will encompass legal, accounting, and financial issues. The Acquisition Lender will then analyze the loan agreement, security agreement, and other documentation related to the proposed loan to own transaction.
- **Borrower relations**. While conducting due diligence, the Acquisition Lender will attempt to obtain the requisite borrower consents (depending on the borrower entity, that may involve board, shareholder, member, or partnership approval) to the loan to own transaction (if necessary). The Acquisition Lender may negotiate and modify certain terms of the agreement to ensure borrower support, as consensual loan to own transactions are generally more successful if the borrower's decision-makers are on board.
- **Documentation**. Once an agreement in principle is reached between the Acquisition Lender and the borrower, the parties will document the surrender of the collateral to the Acquisition Lender and/or the conversion of the Acquisition Lender's debt into equity in the borrower or the direct ownership of the borrower's material assets. The scope and extent of documentation are directly related to whether the loan to own transaction is taking place in a bankruptcy setting or out-of-court. In an out-of-court setting, documentation will include agreements surrendering the assets and/or equity of the company over to the Acquisition Lender and may also include such other documentation as releases for equity and management. Out-of-court documentation is usually kept confidential. If the loan to own transaction is taking place in a bankruptcy court setting, however, the documentation will both be much more extensive and will be made public. Acquisition Lenders will be heavily involved before and throughout the bankruptcy case and, therefore, will have a hand in negotiating everything from DIP credit agreements to bidding procedures to sale motions to Chapter 11 plans—as well as the proposed orders that accompany them. Because these documents are made public, they are also subject to much greater scrutiny from the court and the borrower's other stakeholders. Likewise, a bankruptcy setting requires much greater disclosure about the composition of the Acquisition Lender as well as the consideration it offers in exchange for the intended acquisition.
- **Trade debt for equity/assets**. Generally, the loan to own documentation is conditioned on the exchange of debt for the borrower's assets or equity. A debt for equity transfer may include a release of existing securities, the issuance of new equity to the Acquisition Lender, or the forgiveness of debt. On the other hand, a sale transaction would typically consist of a purchase and sale agreement and contain the provisions generally included in such sale agreements.

Potential Attacks on Loan to Own Transactions

A loan to own transaction can occur either consensually or on a contested basis. When a loan to own strategy is executed consensually, the company's required stakeholders support the transaction. Stakeholder support for a loan to own transaction is greatest when the borrower's value is less than the secured property or when key stakeholders are willing to give up their control in order to gain certain advantages such as releases from liability. Stakeholders may contest a loan to own transaction if they believe that they stand to receive a greater recovery if the company goes through a traditional bankruptcy case, with the assets being administered during the course of the bankruptcy case. The majority of loan to own transactions are contested because obtaining all required stakeholder agreements upfront can be challenging and is more commonly achieved through negotiations that continue during the execution of the transaction itself.

Acquisition Lenders who execute loan to own strategies face several types of risks. First, Acquisition Lenders face the risk of litigation. Parties that acquire debt at significant discounts must be prepared to face a variety of allegations, including that the proposed loan to own transaction constitutes a fraudulent or preferential transfer, that the Acquisition Lender's debt should be recharacterized as equity, that the Acquisition Lender's actions constituted a breach of fiduciary duty, and that the Acquisition Lender's secured claim should be equitably subordinated to the claims of other creditors. For information on such actions, see Fraudulent Transfers, Preferences, Subordination and Recharacterization, Contract- and Tort-Based Lender Liability Claims, and Equitable Subordination. Second, Acquisition Lenders face the possibility of liquidation by the target company and the risk that the company is actually more valuable than the value allocated by the Acquisition Lender. The most common claims are discussed in the sections below.

Lack of Competitive Bidding

Section 363(k) of the Bankruptcy Code enables a court to prohibit or limit a secured creditor's right to credit bid for cause. Cause is an undefined term, and its scope has been the subject of much attention for bankruptcy courts. The upshot of recent Section 363 sale litigation is that courts are willing to undercut a creditor's right to credit bid when (1) the secured creditor's credit bid will unduly chill competitive bidding, (2) the secured creditor engages in inequitable conduct during the bidding process, or (3) there is a bona fide dispute as to the validity of the secured creditor's claim. Once a party objects to the secured party's credit bid, most courts will delay the bid until the merits of the objection have been addressed. Similarly, if the secured debt is secured by less than all of the borrower's assets, the court may limit either the value of the credit bid or the assets over which the credit bid may apply.

Among the causes identified by courts, the most effective strategy for challenging a proposed credit bid is generally to argue that credit bidding will chill competitive bidding, a primary goal of the auction process under Section 363 of the Bankruptcy Code. Opponents of credit bidding typically argue that in the absence of competitive bidding, the estate will likely not receive sufficient cash to maximize the value of its assets or make a distribution to unsecured creditors. Parties opposed to credit bidding often point out the fundamental unfairness of setting the bid threshold at the face value of the debt that was purchased by the Acquisition Lender at a deep discount when the purchase price of the debt, rather than the face amount of such debt, more accurately reflects its market value.

Further, opponents of credit bidding often point out that the party wishing to credit bid will not be prejudiced in any way if the bidding threshold was set at the price at which the debt was purchased. If the Acquisition Lender wishes to acquire the company or its assets, it can simply submit a higher bid with all the usual bid protections, including breakup fees. In this way, opponents of credit bidding assert that as long as there is competitive bidding, the estate has an opportunity to receive cash beyond the Acquisition Lender's investment that can then be used to satisfy general unsecured claims.

The Bankruptcy Code generally protects a secured party's right to credit bid up to the amount of its claim at a Section 363 of the Bankruptcy Code asset sale. Nevertheless, the right to credit bid is not absolute, and courts may limit the right to credit bid for cause. Recent case law demonstrates that courts will find cause in certain situations but not in others. Counsel should review the latest leading decisions to determine whether a proposed loan to own strategy is likely to pass muster with the court based on the specific facts and circumstances of the case involved. Having this information in hand, loan to own lenders can implement strategies that avoid some of the more heavy-handed measures used by secured creditors in the past, always knowing that their right to credit bid may be challenged down the road. Below is a discussion of certain cases concerning the right to credit bid.

Radnor Holdings

In Radnor Holdings Corp. v. Tennenbaum Capital Ptnrs, 353 B.R. 820 (Bankr. D. Del. 2006), the borrower's investment banker invited a hedge fund and two affiliated hedge funds to become involved with the borrower's case. The hedge funds committed to buy $25 million of preferred stock in the company and to loan the company $95 million on a secured basis. As a result of the investment, the hedge funds were given warrants that would allow them to own up to 15% of the company and obtained the right to designate one of the four members of the company's board. The secured loan was used to refinance the company's existing $70 million of senior secured notes and to pay down the existing revolving loan facility. Months later, the company failed to meet its performance targets and entered into an asset purchase agreement and DIP credit agreement with the hedge funds. The asset purchase agreement permitted the hedge funds to purchase all of the debtor's assets as a going concern and to use their secured claims to credit bid at the Section 363 auction sale. The debtor's board formed a special committee of independent directors to evaluate the proposed agreements.

The creditors' committee expressed concern that the hedge funds' ability to credit bid would chill bidding as other potential bidders would be wary of spending the time and effort necessary to submit a competing offer and bid deposit, while the hedge funds could increase their own offer by using more of their secured claims instead of new money. In its complaint, the creditors' committee accused the hedge funds of entering into the loans with no expectation of the debtor being able to repay them but instead as a means to acquire the company pursuant to a loan to own strategy. The committee sought to recharacterize the secured loans as equity or, alternatively, to equitably subordinate the hedge funds' claims to the claims of the general unsecured creditors. Furthermore, the creditors' committee asserted breaches of the fiduciary duties of care and loyalty against the hedge funds and the company's board. The committee also sought to prohibit the hedge funds from using its $128 million in secured claims to make a credit bid for the sale of the debtor's assets.

Ultimately, the Delaware bankruptcy court reinforced a secured lender's ability to take reasonable, market-tested actions to protect its position. The court overruled the objections of the creditors' committee to the stalking horse credit bid of the debtor's pre-petition lender hedge funds, allowing the lenders' claims in full and approving the lenders' credit bid as the highest and best offer for the debtor's assets. This court decision is considered a victory for secured lenders and insiders.

Fisker Automotive

More recent cases suggest that courts are increasingly wary of attempts to use a Section 363 sale credit bid to effectuate a loan to own transaction. After all, an Acquisition Lender's motivation for making a credit bid on the debtor's assets is very different from that of a traditional secured creditor who simply wants to be repaid on its loan.

For example, in another decision by the Delaware bankruptcy court, the right of a secured creditor to credit bid up to the face amount of its claim in a loan to own scenario was again tested. See In re Fisker Automotive Holdings, Inc., 510 B.R. 55 (Bankr. D. Del. 2014). In Fisker, the bankruptcy court allowed the secured creditor to credit bid only $25 million of its claim, which was the amount that it had paid for its secured claim that it had purchased from the Department of Energy and not $75 million, which represented a portion of the $168.5 million outstanding pre-petition debt. The issue in the case was again whether a Chapter 11 plan satisfies the fair and equitable standard if it provides for the sale of collateral without allowing the secured creditor to credit bid its claim and relies instead on the third indubitable equivalent alternative to meet the fair and equitable standard.

Rendering its decision, the bankruptcy court limited the secured creditor's credit bidding rights based on the express language of Section 363(k) of the Bankruptcy Code, which authorizes a secured creditor to credit bid its allowed claim in a Section 363 sale unless the court limits that right for cause. The court held that based on the facts of the case, cause existed under Section 363(k) to limit the secured creditor's credit bid to the amount that it had paid for the claim.

The *Fisker* case opened the door to how broadly courts might define the term cause under Section 363(k) of the Bankruptcy Code in the context of credit bidding. Some bankruptcy practitioners are concerned that *Fisker* may erode the substantial credit bidding rights granted to secured creditors under the Bankruptcy Code. These attorneys assert that Fisker establishes a new rule that the credit bid of a secured creditor that purchased its claims should be limited to the amount paid for such claims.

Other professionals, however, dismiss these concerns, pointing out that *Fisker* was very fact-specific, leading the court to limit the amount of the secured creditor's credit bid for cause because (1) the failure to limit the credit bidding rights would not just chill competitive bidding but would completely eliminate an auction, (2) the extremely rushed sale process was inconsistent with the notion of fairness in bankruptcy, and (3) the secured creditor's lien did not extend to all of the assets to be sold but also included assets in which the secured creditor did not have a perfected lien or in which the lien perfection was a disputed issue.

These professionals argue that *Fisker* is thus consistent with established bankruptcy principles that prevent a secured creditor from using a credit bid for assets in which it may not have a perfected lien or where a truncated sale process threatens competitive bidding. In any event, bankruptcy attorneys representing unsecured and junior creditors are well advised to cite *Fisker* in an attempt to stop secured lenders who may seek to purchase assets by freezing out competition since the *Fisker* court emphasized the need for competitive bidding in these situations.

Post-*Fisker*, courts considering whether to approve credit bidding will examine factors specific to the case (such as whether the secured party's lien was properly perfected), as well as more generalized factors (such as whether credit bidding will lead to an unfair process or freeze out potential buyers). Counsel should anticipate issues that could cause a bankruptcy court to impose restrictions on a secured creditor's right to credit bid. Counsel should carefully analyze a secured creditor's claim and the validity, perfection, and scope of its liens and should draft the governing sale documents in a way that ensures the secured lender's right to credit bid.

When representing a creditor whose liens extend only to some of the collateral being sold, professionals should note in the sale agreement that the secured creditor's right to purchase is subject to court approval of credit bidding procedures acceptable to the bidder on its undisputed collateral and should include a cash bid (or other form of value) for property that is not covered by the lien. Counsel should also be able to justify the reasonableness of the bid amount at the sale hearing before the bankruptcy court.

Free Lance-Star Publishing Co.

Another credit bidding case focused on how courts currently define the "for cause" standard under Section 363(k) of the Bankruptcy Code. See In re Free Lance-Star Publ'g Co., 512 B.R. 798 (Bankr. E.D. Va. 2014). In *Free Lance-Star*, a secured creditor acquired the debtor's secured debt at a discount, with the goal of using the full amount of $38 million to credit bid for the debtor's assets. Other parties objected to the credit bid on the grounds that the lender from whom the secured creditor had acquired its secured debt did not hold valid and perfected liens over certain of the debtor's assets and that the secured creditor had engaged in inequitable conduct.

Ultimately, the bankruptcy court limited the secured creditor's credit bid to $13.9 million. In so deciding, the court relied on the three reasons cited in *Fisker*, adding that it was necessary to limit the secured creditor from bidding the full amount of its claim in order to "foster a fair and robust sale." Given the popularity of Chapter 11 plan sales today and the use of the loan to own strategy, counsel should observe whether other courts will continue limiting credit bids for cause (even without allegations of improper liens or inequitable conduct) simply to always ensure a competitive bidding environment. If so, professionals can expect significant changes in the secondary market for distressed debt. For additional cases and trends, see Market Trends 2021: Credit Bidding. For more information about credit bidding generally, see Credit Bidding.

Bona Fide Dispute as to the Secured Creditor's Claim

Even in the absence of unfair practices that chill the bidding process, a court will still find cause to limit or deny a secured creditor's right to credit bid where the validity of the creditor's lien is subject to a bona fide dispute. The rationale for this being, it would be unfair to the debtor and other stakeholders in the bankruptcy for a creditor to credit bid for assets on the basis of a secured claim that will later be disallowed. When an objection is filed at this stage of the bankruptcy, the court typically has not yet adjudicated allowance of the claim, and it will not require the challenging party to show that it is likely to succeed on the merits of its challenge. Rather, the court will only require a showing that a *sufficient* dispute exists with respect to the lien serving as the basis for the credit bid. See In re Figueroa Mt. Brewing, LLC, 2021 Bankr. LEXIS 1775, at *23 (Bankr. C.D. Cal. July 2, 2021).

One recent unpublished decision explains that a dispute is sufficient to justify the court restricting a credit bid where there is "an objective basis for either a factual or a legal dispute as to the validity of the claim." Id. (quoting In re Dewey Ranch Hockey, LLC, 406 B.R. 30, 39 (Bankr. D. Ariz. 2009)). For example, in *Figueroa*, an "objective basis" existed for a debtor's challenge to a secured creditor's lien on its property because there was evidence suggesting a fraudulent transfer and a lack of good faith in the underlying transfer. Accordingly, the court outright denied the secured creditor's right to credit bid its claim. Other cases that have come to similar conclusions indicate that challenging the validity of a secured creditor's claim can be a promising means of limiting or preventing that creditor's credit bid attempt. See, e.g., In re L. L. Murphrey Co., 2013 Bankr. LEXIS 2318, at *17 (Bankr. E.D.N.C. June 6, 2013) (finding cause where a trustee's allegations in a draft adversary complaint gave rise to a sufficient dispute over the creditor's claim); In re Daufuskie Island Props., LLC, 441 B.R. 60, 64 (Bankr. D.S.C. 2010) (finding a sufficient dispute where a trustee brought a preferential transfer action against a mortgage granted to the purported credit bidder); In re McMullan, 196 B.R. 818, 835 (Bankr. W.D. Ark. 1996) (finding a sufficient dispute where a debtor formally disputed a mortgagee's liens on various grounds).

Breach of Fiduciary Duty

Creditors and shareholders will frequently allege that management, the board, and sometimes the Acquisition Lender have breached their fiduciary obligations or that the Acquisition Lender aided and abetted such breaches. Importantly, to establish a claim for breach of fiduciary duty, an objector must establish that the breach occurred after or as a result of the loan to own transaction entered into with the Acquisition Lender. A breach of fiduciary duty claim in this context cannot be based on the circumstances that preceded the Acquisition Lender's involvement with the borrower (such as the company's poor performance, preexisting business model, bad management, or unmarketable products or services, etc.). As a practical matter, the fact that the Acquisition Lender drove a hard bargain is not typically sufficient to establish a breach of fiduciary duty. More often than not, a loan to own transaction occurs when a borrower is in financial distress and has very limited options. The fact that the Acquisition Lender was able to leverage the borrower's situation to its own advantage, by itself, is not a basis for a breach of fiduciary duty claim.

Breaches of fiduciary duty claims are generally difficult to prove. A breach of the duty of care can be shown if the board failed to consider all available options, failed to obtain advice from independent professionals, failed to read critical documents, or failed to devote sufficient time to considering the loan to own transaction. Similarly, if an objector can show that the proposed transaction stood to benefit management and directors personally, such a conflict of interest could rise to a breach of fiduciary duty. However, even if such elements can be proven, the business judgment rule and the fairness standard give directors wide discretion and broad protection when making decisions on behalf of a company. Most Acquisition Lenders who exercise loan to own strategies are sophisticated enough and take specific actions to avoid allegations of breach of fiduciary duty. Such measures include retaining only a minority ownership interest in the company and refraining from participating in critical board decisions. Most case law finds that an Acquisition Lender's board membership alone is not a ground for liability.

A second ground for establishing a breach of fiduciary duty against a loan to own Acquisition Lender is a claim for deepening insolvency. Under this theory, an objector alleges that by entering into the loan to own transaction with the Acquisition Lender, management and the board worsened the company's financial situation, and that the Acquisition Lender aided and abetted the borrower's slide into bankruptcy. However, the theory of deepening insolvency has been called into question. Many courts find that directors have no obligation to liquidate a distressed company and do not need to guarantee the success of the business decisions that they implement. These courts further hold that deepening insolvency has no place in a new financing arrangement because many new financings add value by opening credit and increasing assets. As a result, counsel should not rely on deepening insolvency as a successful basis for breach of fiduciary duty claims. For more information on fiduciary duties and deepening insolvency, see Fiduciary Obligations of Officers and Directors.

Equitable Subordination

Other arguments may also be asserted to establish cause to limit or condition a loan to own Acquisition Lender's credit bid. Under Section 510(c) of the Bankruptcy Code, if the Acquisition Lender or the borrower engaged in inequitable conduct that injured other creditors, the Acquisition Lender's claims may be equitably subordinated to the claims of the injured creditors. In accordance with case law, inequitable conduct typically includes fraud, illegality, breach of fiduciary duty, undercapitalization, and use of the company as an alter ego. Counsel should note that the preexisting financial condition of the borrower that preceded the transaction with the Acquisition Lender cannot serve as a valid ground for equitable subordination of the Acquisition Lender's claims. As noted above, the fact that the Acquisition Lender drove a hard bargain and had the upper hand under the circumstances does not rise to the level of tortious conduct.

Equitable subordination claims are usually alleged against corporate insiders (which would include an Acquisition Lender who also holds equity in the company), but such claims can be alleged against non-insiders as well. A bankruptcy court has discretion to equitably subordinate claims even without creditor misconduct, if the court deems that doing so is necessary to prevent injustice and ensure fairness for creditors.

Equitable subordination is most likely to be granted when:

- It is clear that the borrower and the Acquisition Lender knew from the outset that the debt would likely not be repaid and that a different arrangement would be required
- The underlying loan documents include covenants that cannot be satisfied and contemplate a default
- The parties establish unrealistic time frames for proposing a restructuring plan or achieving certain financial targets –and–
- The transaction includes a plan for the borrower to file a bankruptcy petition, at which time the Acquisition Lender will assume control over the company

If any of these factors is accompanied by prejudice or harm to creditors, the grounds for equitable subordination are strongest. However, establishing harm to general unsecured creditors can be difficult because an Acquisition Lender that intends to take control of the borrower's company will likely extend financing to enable the borrower to pay necessary trade creditors. Likewise, an Acquisition Lender that intends to reorganize the company in bankruptcy will likely pay creditor claims to ensure smooth continued business operations. Notably, establishing harm to bondholders is even more difficult since, in distressed situations, bondholders are often completely out of the money by the time that the Acquisition Lender gets involved with the company.

Alternatives and Valuation

As a way of attempting to defeat a credit bid, a creditor or other objector can argue that the company's management failed to seek out other alternative transactions. To prevail with such an argument, the objector to the credit bid must establish that the borrower did not investigate other proposals, did not consider other reasonable transactions, or that the borrower's search for alternative transactions was too restrictive in scope. At the same time, however, counsel should take a realistic approach and consider the possibility that based on the borrower's financial condition and its need for immediate financing, few higher or better alternatives would have been available. If the borrower can show that it took reasonable steps to explore other alternatives and employed seasoned professionals to assist in that effort, the borrower's process will likely be upheld by the court.

As a practical matter, an argument based on potential alternatives is fact-based and difficult to prove. Among other things, when challenged, the borrower can simply indicate that it accepted the Acquisition Lender's proposal based on the company's immediate need for financing to avoid a default on its obligations. To further dilute allegations that the borrower did not adequately pursue alternatives before deciding on the loan to own transaction, a company may wish to have outside independent professionals evaluate all proposals and make the ultimate decision to pursue the loan to own strategy. In doing so, management and directors will be protected from any allegations of self-interest or self-dealing.

On a related note, an objecting party can seek to defeat a credit bid by asserting that the Acquisition Lender's transaction understated the borrower's actual value. The difficulty with this argument is that value is always a fact-based inquiry. Courts have become skeptical of expert testimony in this area, pointing out that valuation results vary significantly based on the variables used and that essentially any valuation needed can be created using certain metrics. As a result, courts regularly give less weight to a creditor's subjective valuation when the Acquisition Lender's valuation is based on the market valuation in effect at the time of the transaction. Such courts view the market as the most accurate indicator and predictor of value. As such, the chances are quite slim of persuading a court that the value of the company was substantially greater than the Acquisition Lender's and borrower's valuation.

Good Faith

Another basis for challenging a loan to own transaction is a lack of good faith. In accordance with the Bankruptcy Code, a plan may be confirmed only if it was proposed in good faith. Most courts find that in order to satisfy the good faith standard, the plan must have been proposed with honesty and good intentions and with a basis for expecting that a reorganization could successfully be effected.

Applying this standard, if the facts point to a lack of good faith, an objector could allege that the Acquisition Lender proposed a plan under the guise of rehabilitating the company but with the actual motive of converting its own debt into a controlling equity position within the company. For general information on the lack of good faith argument, see Confirmation Objections — Common Section 1129(a) Objections.

Recharacterization

In an effort to prevent, limit, or condition credit bidding, an objector can seek to recharacterize the debt owed to the Acquisition Lender as equity. In that case, the debt would not be permitted to be included in a credit bid. Pursuant to the Bankruptcy Code, courts have broad discretion to order recharacterization when the facts demonstrate that a debt transaction was actually an infusion of equity. To avoid recharacterization, loan to own transactions almost always include separate debt and equity documents. The Acquisition Lender also takes care to make the transaction look like a loan. To this end, the Acquisition Lender will monitor the loan, enforce events of default, require timely payments of interest and principal, include typical covenants in the loan documents, and require the borrower to provide necessary financial information. Upon an event of default, the Acquisition Lender will take the same action as a typical lender, at all times keeping its equity stake separate.

Generally, the fact that the Acquisition Lender holds both debt and equity in the company is not sufficient to establish grounds for recharacterization. In determining whether to recharacterize debt, courts often consider, among other things:

- The intent of the parties
- The adequacy of the company's capitalization
- The name of the debt instruments

- How the interest between the lender and the borrower is described
- Whether the instrument contains an interest rate, maturity rate, and payment schedule
- The collateral securing the loan
- Whether the company could have obtained alternative financing
- Whether advances were used to acquire capital assets
- The ratio of shareholder loans to capital –and–
- The amount of shareholder control over the transaction

As a matter of policy, courts are hesitant to recharacterize a loan as equity so as not to discourage lending when borrowers need it the most. Thus, the more that a debt transaction has the characteristics of a debt transaction, the more likely the court will treat the transaction as such. Similarly, the risk of recharacterization is lessened when an Acquisition Lender acquires debt that was not originated in connection with a loan to own strategy. Nevertheless, as long as the Acquisition Lender keeps its debt and equity hats separate and does not attempt to use its creditor status to advance its position as an equity holder or vice versa, the loan will probably stand. At that point, the Acquisition Lender can use its leverage as a creditor to call a default and implement a restructuring or bankruptcy filing that will ultimately give it an ownership position in the company. Significantly, in effectuating this strategy, the Acquisition Lender must remove itself from all voting on such types of transactions and must ensure participation by independent directors. If the Acquisition Lender takes the proper precautions before the bankruptcy filing, the borrower will have few other options but to effectively tender ownership of the business to the Acquisition Lender. For more information on recharacterization, see Loan Recharacterization and Equitable Subordination versus Debt Recharacterization.

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David Wender is a partner with Alston & Bird's Financial Restructuring & Reorganization Group. David represents a variety of clients in complex bankruptcy cases, out-of-court workouts, debt restructurings, asset dispositions, and claims reconciliation procedures. He represents purchasers, sellers, and other parties in bankruptcy Section 363 sales; debtors in possession; secured and unsecured creditors; and creditor's committees.

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Before joining Alston & Bird, David served as law clerk to the Honorable Mary F. Walrath, chief U.S. bankruptcy judge for the District of Delaware. He received his J.D. in 2003 from the Emory University School of Law and his B.S. in business administration from Washington University in St. Louis in 1998.

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