CREDIT BIDS

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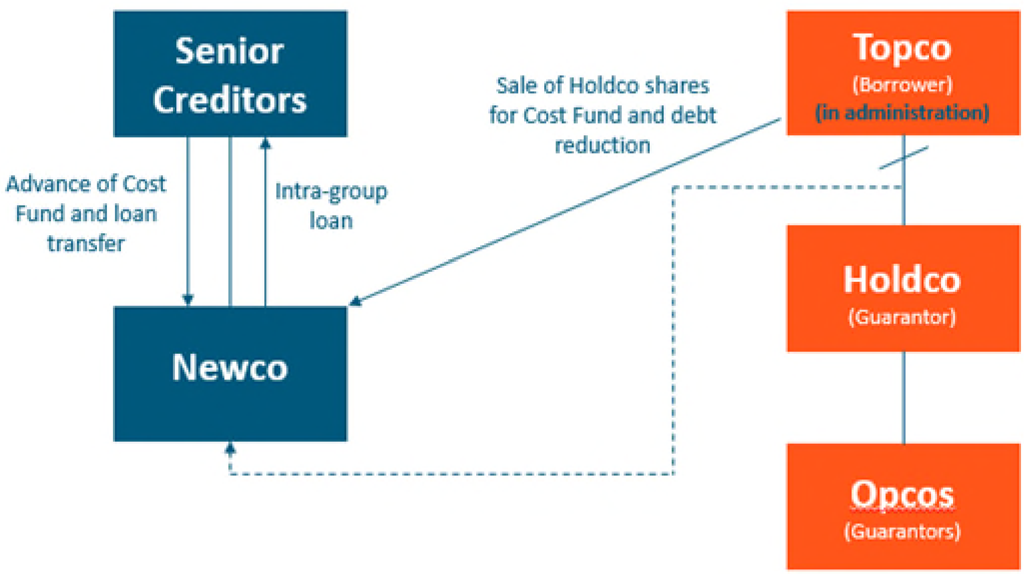
BRYAN CAVE LEIGHTON PAISNER

WHAT IS A CREDIT BID?

In certain circumstances, a secured lender can 'bid' its secured claim against the purchase price in a sale of the secured assets. The secured lender can compete with cash bids for the collateral, bidding up to the face value (principal and accrued unpaid interest) of its secured obligation. Rather than paying cash for the collateral, the secured lender can offset the purchase price by the value of its outstanding claim against the collateral.

TYPICAL STRUCTURE OF A CREDIT BID



WHY ARE CREDIT BIDS USED?

Credit bids can protect value in the collateral when asset values are depressed, and avoid the secured lender from being cashed out by a third party for less. By offsetting the purchase price against the claim, the acquisition can be cash-free apart from taxes, professional costs and frictional costs. The credit bid can form part of a 'loan-to-own' strategy, where the secured lender actively wants to take ownership of the collateral.

DOWNSIDE MITIGATION

Where asset values are deteriorating, credit bids can be used defensively to set a "floor" on value.

Best case

It creates competitive tension and an acceptable cash bid.

Worst case

The collateral can be warehoused by the secured lender

But, there is a risk of the credit bid having a chilling effect on third party interest, which may have to be taken into account in determining whether any auction process has benchmarked a fair market value.

AS PART OF A "LOAN-TO-OWN" STRATEGY

The growth in alternative debt providers' appetites for acquiring assets from distressed companies has seen a rise in credit bidding as a loan-to-own strategy, and many of them will have experience of credit bidding in asset sales undertaken in Chapter 11 bankruptcy processes.

Loan-to-own strategies involve providing or purchasing (in the secondary market and typically at a discount) the distressed company's secured debt.

This is done with a view to enforcing the security and acquiring shares in, or assets of, the obligors, often by way of a pre-packaged administration sale.

Fair market value has to be achieved, but distressed sales processes are usually undertaken at speed and there may be an implied discount for distress. Furthermore, the secured lender can bid the face value of the debt, not what they paid for it.

WHAT ARE THE RISKS AND ISSUES TO CONSIDER?

Security

Valid security over the assets to be acquired is essential, and a security audit will be required before buying into the loan.

Ranking and intercreditor arrangements

If the secured lender is not first ranking, it will have to consider carefully its tactics opposite the senior lenders. Any intercreditor agreement will need to be carefully examined to ensure the transaction can be executed and on what terms. Points to consider include junior lenders' right to information and right to buy senior debt at par; ability for security trustee to accept non-cash consideration; consent requirements; release provisions; and powers of attorney.

Valuation

Careful consideration of where the value breaks is critical, to determine how high a bid can be made before cash must be paid and when the interests of more junior creditors have to be taken into account. Where the assets are not being exposed to market, valuations must be obtained. If assets are contingent in nature, the credit bid will typically be in excess of the valuation to minimise the risk of challenge.

Cash element of consideration

The fees of the officeholder will have to be cash funded. If there are floating charge assets, cash will also be required to fund any prescribed part that would have been available to unsecured creditors from realisations attributable to those assets.

Deferred consideration

Credit bid transactions do not typically include a deferred consideration element. This could be relevant if leasehold property is being acquired because it can support the continuation of the administration moratorium, protecting against forfeiture, while assignments with landlords are negotiated.

Debt obligation

Where the debt and security sits in the obligor group may influence the acquisition strategy. The seller of the assets will usually owe the primary debt obligation. If a seller of assets is a guarantor of the secured debt, rather than a primary borrower, it may be possible to crystallise the guarantee in certain circumstances. However, care will need to be taken to ensure that the guarantee claim will not be reduced below the value of the assets to be acquired by other pockets of value within the group.

Syndicated loans

Each lender in a syndicated facility will have a claim, but the security is held by a security trustee. In theory, a single lender could make a credit bid. However, recoveries will typically need to be shared on a pro rata basis between lenders (which is unworkable unless lenders will accept a cash equivalent) and the assets will remain subject to the secured claims of the other lenders unless the security is released.

Taxes

Tax implications will need to be carefully considered. It is usually possible to structure credit bid transactions in a tax efficient manner so that the assets are acquired subject to the existing debt and security, for a nominal consideration. However, issues that may need to be considered include:

Transaction taxes such as stamp duty and SDLT may arise. If companies are being acquired then the possibility of "de-grouping" charges arising in the acquired companies needs to be considered.

VAT

Are the requirements for a (VAT-free) "transfer of a going concern" going to be met?

Corporation tax

If debt has been acquired on a distressed basis, does any taxable profit arise in the bidding creditor?

Releases of debt and "deemed releases"

The UK has complicated tax rules that apply where a company's debt is released or written off, or where a distressed debt is acquired by a person connected with a company, or where the debtor and creditor of a distressed debt become connected. Care will need to be taken with structuring any transaction that has any of these features.

Getting in touch

When you need a practical legal solution for your next business opportunity or challenge, please get in touch.

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