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Limitations on Secured Creditors' Rights to Credit Bid

Earlier this year, we reported on a decision limiting a secured creditor's right to credit bid purchased debt (capping the credit bid at the discounted price paid for the debt) to facilitate an auction in Fisker Automotive Holdings' chapter 11 case.[1] In the weeks that followed, the debtor held a competitive (nineteen-round) auction and ultimately selected Wanxiang America Corporation, rather than the secured creditor, as the winning bidder.

Was *Fisker* an anomaly? Perhaps not. On April 14, 2014, the United States Bankruptcy Court for the Eastern District of Virginia issued a decision following *Fisker* and limiting the amount a secured creditor can credit bid.[2] The decision, which also criticizes the secured creditor's "overly zealous loan-to-own strategy," may signal greater judicial willingness to consider secured creditors' conduct and motives when determining their credit bid rights.

Background

In 2006, The Free Lance-Star Publishing Co. of Fredericksburg, VA ("The Free Lance-Star"), a family-owned publishing, radio, communications and newspaper company, and a related entity (together, the "debtors"), tried to expand their commercial printing business. To do so, they obtained a $50.8 million secured loan from Branch Banking and Trust ("BB&T").

In 2009, the debtors could no longer comply with various covenants in the BB&T loan agreement. They remained current on payments and entered into a forbearance agreement. In 2013, BB&T sold its loan to Sandton Capital Partners ("Sandton"). Sandton quickly made clear to the debtors that it wanted them to file chapter 11 cases and sell substantially all of their assets to Sandton in a section 363 sale. The debtors agreed to prepare for a bankruptcy filing and asset sale.

Counsel for DSP Acquisition, LLC ("DSP") – an entity reportedly affiliated with, and operated by, Sandton and that held the BB&T note – requested that the debtors execute deeds of trust for some real estate parcels (together with related assets used for the debtors' radio broadcasting operations, the "Tower Assets"). During a break in negotiations, DSP filed UCC fixture financing statements, without notice to the debtors. Shortly thereafter, DSP delivered a revised forbearance agreement that included a blanket release of DSP, but no additional mortgages or liens on the Tower Assets. DSP explained that it expected that the Tower Assets would be part of its planned DIP facility collateral package.

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[1] *In re Fisker Automotive Holdings, Inc.*, 2014 WL 210593 (Bankr. D. Del. Jan. 17, 2014) ("*Fisker*")

[2] *In re The Free Lance-Star Publishing Co. of Fredericksburg, VA*, 2014 Bankr. LEXIS 1611 (E.D. Va. April 14, 2014)("*The Free Lance-Star*").

Ninety days after DSP recorded the UCC fixture filings, it resumed its campaign for a quick chapter 11 filing and an aggressive asset sale timeline.[3] Negotiations between DSP and the debtors broke down after the debtors' financial consultants concluded that the company could survive in bankruptcy without a DIP loan by using available cash collateral. DSP insisted that the company enter into a DSP-sponsored DIP loan. After the debtors refused the proposed financing, DSP withdrew its support for a bankruptcy filing and recorded additional financing statements, again without notice to the debtors.

On January 23, 2014, the debtors filed their chapter 11 cases and DSP objected to their use of cash collateral. DSP requested liens on the Tower Assets as adequate protection, which the Bankruptcy Court denied. DSP did not disclose to the Court or the debtors that it had already recorded financing statements against the Tower Assets in August 2013 and January 2014.

The March Hearing

On January 23, 2014, the debtors filed two sale motions, one to sell business assets and the other to sell the Tower Assets (the "Sale Motions"). As filed, the Sale Motions permitted DSP to credit bid its secured claims, to the extent of its valid liens or security interests; the Bankruptcy Court scheduled a hearing to consider the extent of DSP's liens for late March 2014 (the "March Hearing").

At the March Hearing, the Court ruled that DSP did not have valid, properly perfected liens on the Tower Assets, among other property.[4] The Court also found that DSP had engaged in inequitable conduct that, under the circumstances, constituted "cause" to cap the amount of DSP's credit bid, not at the $39 million loan amount, but at $1.2 million for assets related to the debtors' radio business and $12.7 million for assets related to the debtors' newspaper and printing business.[5]

Analysis

The Court noted that while the ability to credit bid is an "important safeguard that insures against undervaluation of the secured claim at an asset sale," that ability is not absolute. Relying primarily on *Fisker*, Judge Huennekens held that courts may limit or deny a secured creditor's ability to credit bid its debt to facilitate a fully competitive auction, particularly where a secured lender's inequitable conduct had chilled bidding.

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3 Under the Bankruptcy Code, preferential transfers to non-insiders may be avoidable if they were made on or within ninety days before the date that the petition was filed. 11 U.S.C. §547.

4 The Court's finding of facts and conclusions of law are set forth in its April 14, 2014 decision.

5 It is not clear from the decision or the March Hearing transcript how these amounts were selected. DSP declined to put on any expert testimony during the March Hearing, and, perhaps mindful of Fisker, has not disclosed its purchase price for the BB&T loan.

Judge Huennekens noted that he was "troubled" that DSP unilaterally recorded UCC fixture financing statements twice, "disappointed" that DSP failed to disclose these UCC filings during the contested cash collateral hearing and "equally troubled" by DSP's attempts to "frustrate the competitive bidding process."

He characterized DSP's acquisition as "a classic loan-to-own scenario" and ventured that the credit bid mechanism to protect secured lenders against undervaluation of collateral "does not always function properly when a party has bought the secured debt in a loan-to-own strategy in order to acquire the target company." The Court found that DSP "has tried to depress the sales price of the Debtors' assets, not to maximize the value of those assets." The Court concluded that "the confluence of (i) DSP's less than fully-secured lien status; (ii) DSP's overly zealous loan-to-own strategy; and (iii) the negative impact DSP's misconduct has had on the auction process has created the perfect storm, requiring curtailment of DSP's credit bid rights."

Conclusion

While the impact of *Fisker* and now, *The Free Lance-Star*, on credit bidding and strategic acquisitions of distressed debt remains to be seen, these decisions may signal an increased willingness by bankruptcy courts to scrutinize a secured creditor's motives and conduct before permitting a credit bid and a possible shift in what courts will view as "acceptable" secured creditor conduct. Certainly, these decisions encourage other constituencies to mount challenges to open up the sale process and, potentially, to generate more cash. *The Free Lance-Star* may not be the last word on DSP's credit bid rights, as DSP is appealing the decision.

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Kelley A. Cornish
212-373-3493
kcornish@paulweiss.com

Douglas R. Davis
212-373-3130
ddavis@paulweiss.com

Alice Belisle Eaton
212-373-3125
aeaton@paulweiss.com

Brian S. Hermann
212-373-3545
bhermann@paulweiss.com

Alan W. Kornberg
212-373-3209
akornberg@paulweiss.com

Elizabeth R. McColm
212-373-3524
emccolm@paulweiss.com

Andrew N. Rosenberg
212-373-3158
arosenberg@paulweiss.com

Jeffrey D. Saferstein
212-373-3347
jsaferstein@paulweiss.com

Stephen J. Shimshak
212-373-3133
sshimshak@paulweiss.com

Erica G. Weinberger and Ann K. Young contributed to this client alert.