

Client Alert

Financial Restructuring Practice Group

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In re Free Lance-Star Publishing Co.—Virginia Bankruptcy Court Restricts Secured Creditor's Ability to Credit Bid

The United States Bankruptcy Court for the Eastern District of Virginia (the “**Court**”) issued an opinion limiting the ability of a “loan to own” secured creditor to credit bid at an auction for the sale of substantially all of the debtors’ assets.¹ The Court focused on the fact that the creditor’s conduct interfered with the sale process and was motivated by its desire to “own the Debtors’ business” rather than to have its debt repaid. The Court’s decision suggests that secured creditors who “loan to own” may jeopardize their right to credit bid by being overly aggressive prior to or after the bankruptcy filing in their efforts to minimize competitive bidding.

Background

The Free Lance-Star Publishing Company of Fredericksburg, VA and its affiliate William Douglas Properties, LLC (the “**Debtors**”) operated a family-owned publishing, newspaper, radio, and communication company. Among other assets, the Debtors owned three parcels of real estate that contained towers used in the Debtors’ radio broadcasting business (“**Tower Assets**”). As part of an expansion in the mid-2000s, the Debtors borrowed approximately \$50.8 million (the “**Loan**”) from Branch Banking and Trust (“**BB&T**”). The Debtors granted BB&T liens and security interests in certain real and personal property, but did not provide the Tower Assets as collateral for the Loan.

The expansion was complete in 2009, just as the Debtors’ deteriorated financial condition caused the Debtors to fail to comply with certain of the Loan’s covenants. After restructuring and refinancing options failed to materialize, BB&T sold the Loan to Sandton Capital Partners (“**Sandton**”) in mid-2013. Sandton promptly informed the Debtors that it wanted the Debtors to file bankruptcy and sell substantially all of their assets to Sandton. The Debtors agreed to work on a plan to sell the business to Sandton, pursuant to section 363 of the Bankruptcy Code.

Prior to the Debtors’ bankruptcy filing, Sandton apparently transferred ownership of the Loan (or a portion thereof) to its affiliate, DSP Acquisition, LLC (“**DSP**”).² Near the end of July 2013, DSP learned that it does not have a lien on the Tower Assets and asked the Debtors to pledge those assets to it. DSP shared with the Debtors its “Restructuring Timeline,” which anticipated

For more information, contact:

Sarah R. Borders
+1 404 572 3596
sborders@kslaw.com

Jeffrey R. Dutson
+1 404 572 2803
jdutson@kslaw.com

Karen D. Visser
+1 404 572 4603
kvisser@kslaw.com

King & Spalding
Atlanta
1180 Peachtree Street, NE
Atlanta, Georgia 30309-3521
Tel: +1 404 572 4600
Fax: +1 404 572 5100

a pledge of the Tower Assets prior to the Debtors' expected bankruptcy filing in September 2013 and clearly communicated DSP's expectation that the Debtors would grant DSP a lien on the Tower Assets as a condition to DSP's extending DIP financing to the Debtors. Negotiations between the Debtors and DSP "stopped abruptly" in mid-August 2013. Thereafter, when the Debtors failed to execute the pledge of the Tower Assets, DSP unilaterally, and without the Debtors' knowledge, filed UCC Fixture Filing Statements with regard to the Tower Assets.

Subsequently, DSP and the Debtors resumed negotiations, but once the ninety-day period following the filing of its UCC Fixture Filings had passed, DSP began pressuring the Debtors to file bankruptcy. Throughout the negotiations, DSP attempted to convince the Debtors that they did not need to market the assets and should limit the sale process to no more than six weeks from the petition date. DSP also objected to the Debtors' retention of Protiviti, Inc. ("Protiviti") as their financial consultant and, when Protiviti insisted on distributing marketing materials, DSP insisted that the materials prominently disclose DSP's right to credit bid its debt. The relationship between DSP and the Debtors "soured" when Protiviti's cash flow projections indicated that the Debtors would not require a DIP facility and the Debtors refused to negotiate one with DSP. As a result, in January 2014, DSP revoked its support of a bankruptcy filing and, without notice to the Debtors, filed additional financing statements on the Debtors' assets in various jurisdictions.

The Bankruptcy Filing

After the Debtors filed their voluntary bankruptcy petitions on January 23, 2014, DSP objected to the Debtors' motion to use cash collateral and sought new liens on the Tower Assets as adequate protection. The Court denied that request, finding that DSP was adequately protected.³ DSP failed to disclose to the Court that it had recorded financing statements against certain of the Debtors' assets in August 2013 and again in January 2014.

The Debtors filed a motion to sell their assets, which included a request to approve the bidding procedures and to limit DSP's right to credit bid. The Debtors asserted that, under section 363(k) of the Bankruptcy Code,⁴ "cause" existed to prevent DSP from exercising its right to credit bid because: (1) DSP's liens did not encumber all of the assets to be sold; (2) DSP had engaged in inequitable conduct toward the Debtors that had "damped interest in the auction and depressed the potential sales price"; and (3) limiting DSP's right to credit bid would foster "a robust bidding process."⁵

Analysis and Holding

Following an evidentiary hearing, the Court held that DSP's right to credit bid should be limited, but not extinguished, because: (1) DSP could credit bid only on the assets that were included in its collateral pool; (2) DSP's "loan-to-own strategy" had "depressed enthusiasm for the sale in the marketplace"; and (3) such a limitation would "attract renewed interest in the bidding process."⁶

In reaching this conclusion, the Court first held that section 363(k) provides a secured creditor a right to credit bid only with respect to the sale of the creditor's collateral. The Court stressed that the right to credit bid is designed to ensure that the secured creditor is permitted to bid up the price for its collateral as high as its claim amount.⁷ Second, the Court noted that, where a creditor does have a perfected security interest in the property to be sold, the right to credit bid is not absolute and can be limited if the Court "for cause order[s] otherwise."⁸ Such "cause" includes a finding that limiting the right to credit bid is in the "interest of any policy advanced by the [Bankruptcy] Code," including ensuring a successful reorganization or fostering "a competitive bidding environment."⁹ The Court also relied on the bankruptcy court's holding in *In re Fisker Automotive Holdings, Inc.*, Case No. 13-13087-KG, 2014 Bankr. LEXIS 230, at *15-17 (Bankr. D. Del. Jan. 17, 2014)), that "cause" exists under section 363(k) when a secured creditor's inequitable actions have "chilled the bidding process."¹⁰

Although the Court was particularly concerned with DSP's false disclosures and nondisclosures, the Court's reasoning focused heavily on the fact that DSP had attempted to use the credit bidding mechanism to chill the bidding to ensure that it could purchase the Debtors' business, rather than what the Court viewed as the intended purpose of credit bidding—protecting a secured creditor from the undervaluation of its collateral.¹¹ The Court found that a limit on DSP's credit bid was necessary because DSP's "misconduct" had interfered with the sale process by depressing, rather than maximizing, the value of the assets at the expense of the Debtors' other creditors.¹²

To remedy the harm caused, the Court limited DSP's right to credit bid to \$1,200,000 for the Debtors' radio-related assets and \$12,700,000 for the assets related to the newspaper and printing business. The Court did not explain in any detail how these numbers were determined, but relied upon testimony from the Debtors' financial advisor, Protiviti. The Court emphasized that the allowed amount of DSP's credit bid was not intended to correspond to a valuation of the Debtors' business or DSP's collateral; instead, the limitation simply represented an effort to establish an "appropriate cap for a credit bid that would foster a competitive auction process."¹³

Lessons Learned

DSP's actions in this case provide a clear roadmap for what secured creditors seeking to credit bid should not do. First, prior to purchasing a loan, a buyer must thoroughly diligence the extent and validity of the liens securing the loan. Credit bidding is permitted only with respect to assets on which the creditor has a perfected lien.¹⁴

Second, secured creditors should avoid exercising excessive control over the borrower and any sale process. The Court found that DSP aggressively pushed the Debtors toward bankruptcy and pressured them to shorten the sale process. Furthermore, when Protiviti insisted upon distributing marketing materials to other potential purchasers, DSP required that the front page of the materials contain a statement, in bold, that DSP had a right to a \$39 million credit bid. This behavior strongly supported the Debtors' argument that DSP was simply using its credit-bid right to stifle the marketing process.

Third, adequate disclosure to the court is vital. The Court found that DSP had not been forthcoming with respect to certain of its pre-petition activities related to the perfection of its liens. The Court noted that it was "troubled," "concerned," and "disappointed" with DSP's lack of disclosure and certain false statements in declarations filed by DSP. Although this may not have been a controlling factor in the Court's legal analysis, it certainly colored the Court's view of DSP's conduct.

Credit bidding is an important safeguard for ensuring that a secured creditor realizes the full value of its collateral. Following closely on the heels of the *Fisker* decision by the Delaware Bankruptcy Court, this case will draw substantial attention from secured lenders, distressed investors, and the professionals that represent them. This case serves as a reminder that courts are increasingly willing to find cause to limit credit bidding. Secured creditors should make every effort to avoid the pitfalls identified above.



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¹ Memorandum Opinion, *In re The Free Lance-Star Publ'g Co. of Fredericksburg, VA*, Case No. 14-30315-KRH (Docket No. 185) (Bankr. E.D. Va. Apr. 14, 2014) (“**Memo. Op.**”).

² The Court noted the lack of any evidence to support such a transfer, but presumed for purposes of the decision that DSP was the holder of the debt and allowed DSP an opportunity to provide proof of ownership that was satisfactory to the Debtors and the Committee prior to the auction. *Id.* at 16 n.14.

³ In an adversary proceeding filed by DSP to determine the extent and validity of DSP’s liens, the Court held that DSP did not have perfected liens on a portion of the Debtors’ assets, including the Tower Assets, FCC licenses, motor vehicles, life insurance policies, and bank accounts. *See Order and Memorandum Opinion, DSP Acquisition, LLC v. The Free Lance-Star Publ'g Co. of Fredericksburg, VA et al.*, Adv. Pro. No. 14-03038, at 11-12 (Bankr. E.D. Va. Apr. 14, 2014). The Court also concluded that DSP’s lien on the Debtors’ “payment intangibles” did not constitute a lien on the sale proceeds attributable to the unencumbered assets.

⁴ Section 363(k) of the Bankruptcy Code states: “At a sale under [section 363(b)] of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.” 11 U.S.C. § 363(k).

⁵ *Memo. Op.* at 11.

⁶ *Id.* at 15.

⁷ *Id.* at 9.

⁸ *Id.* at 10 (citing *In re Antaeus Tech Servs., Inc.*, 345 B.R. 556, 565 (Bankr. W.D. Va. 2005); *In re Fisker Auto. Holdings, Inc.*, Case No. 13-13087-KG, 2014 Bankr. LEXIS 230, at *15-17 (Bankr. D. Del. Jan. 17, 2014)).

⁹ *Id.* (quoting *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 315-16 (3d Cir. 2010)).

¹⁰ *Id.* at 11.

¹¹ *Id.* at 13.

¹² *Id.* at 13, 15.

¹³ *Id.* at 14-16.

¹⁴ DSP is pursuing an appeal of the Court’s decision, and the majority of the issues on appeal relate to the perfection and validity of DSP’s liens. *See Amended Motion of DSP Acquisition, LLC for Certification and Leave to Appeal, In re The Free Lance-Star Publ'g Co. of Fredericksburg, VA*, Case No. 14-30315-KRH (Docket No. 191) (Bankr. E.D. Va. Apr. 15, 2014).