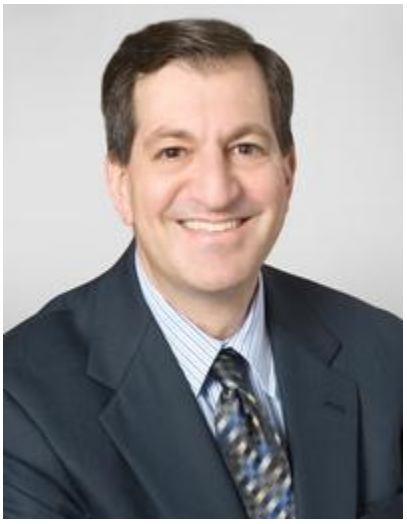
Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Another Case To Further Fisker's Credit-Bid Uncertainty



Law360, New York (May 09, 2014, 12:44 PM ET) -- A few months ago, a ruling in the Chapter 11 case of Fisker Automotive narrowed a secured creditor's right to credit-bid its debt in connection with a sale of the debtor's assets. The decision surprised many observers and resurrected uncertainty about a debtor's ability to limit a secured lender's credit-bidding rights (a dispute that appeared to have been firmly resolved in favor of secured creditors only two years ago by the U.S. Supreme Court's decision in RadLax Gateway Hotel).

Fisker Automotive put the issue of credit bidding back on the table, particularly in so-called "loan to own" situations where secured debt is purchased at a substantial discount for the purpose of effecting the acquisition of a distressed borrower. An opinion issued recently in the Chapter 11 case of Free Lance-Star Publishing Co. is certain to further the uncertainty.

Section 363(k) of the Bankruptcy Code provides that secured creditors may credit-bid the full amount of their debt when their collateral is sold, "unless the court for cause orders otherwise ...." Credit-bidding in bankruptcy protects the expectations of secured creditors under nonbankruptcy law to be able to look to their collateral in the event of a default.

The Bankruptcy Code does not define what constitutes "cause," but it has generally been viewed as being narrow in scope, such as a creditor's bad faith or misconduct. A controversy arose a few years ago when the U.S. Court of Appeals for the Third Circuit unexpectedly limited a secured creditor's right to credit-bid in the absence of "cause" in the Philadelphia Newspapers case. That decision was effectively overruled by the Supreme Court's ruling in RadLax.

The new dispute over credit bidding arising from Fisker Automotive and Free Lance-Star Publishing Co. turns on how broadly courts can define the meaning of "for cause" under Section 363(k). Specifically, can "cause" be based solely on the goal of fostering a competitive auction process? Moreover, could the credit-bidding rights of purchasers of debt for less than face value be different from those of original lenders?

In Fisker Automotive, Judge Kevin Gross granted a motion to cap the right to credit-bid "for cause" of Hybrid Tech Holdings, a secured creditor that purchased a $165 million loan at a substantial discount. There was a genuine dispute as to the extent of Hybrid's security interests on Fisker's assets (at least a portion of the assets that were to be sold did not appear to be encumbered by Hybrid's liens, and therefore could not be the subject of a credit bid), and Gross also excoriated Hybrid's actions during the case, thus inferring inequitable conduct. A ruling that "cause" existed to limit credit bidding for these reasons would not have been particularly remarkable.

However, the decision also suggested a much broader reading of the term, "for cause." Gross ruled that Hybrid's right to credit-bid could be limited to $25 million (the amount it paid to acquire the loan) on the basis that it would improve the ability of other bidders to compete at an auction. He wrote, "bidding will not only be chilled without the cap; bidding will be frozen." This last statement raised numerous eyebrows, suggesting as it did that credit bidding could be limited even in the absence of any malfeasance by the holder of the debt.

The first shoe following Fisker Automotive has now dropped. The facts of Free Lance-Star Publishing Co. are in many ways similar to Fisker Automotive.

A secured creditor, DSP, acquired the secured debt of Free Lance-Star Publishing at a discount, intending to use the full face amount of $38 million to credit-bid for the debtor's assets. The debtor and the creditors committee objected to the credit bid, contending that the lender from which DSP acquired its secured debt did not hold valid and perfected liens over certain of the debtor's key assets, including Federal Communications Commission licenses and the real property on which the debtor's radio transmission towers sit, and alleging various forms of "inequitable conduct" on the part of DSP.

Unsurprisingly, the debtor and the creditors committee also cited Gross' statement in Fisker Automotive, arguing that "cause" existed to limit DSP's right to credit-bid in order to avoid chilling the bidding process and to "restore enthusiasm" for the sale.

Judge Kevin Huennekens held that DSP's credit bid will be limited to $13.9 million. His opinion noted the three separate arguments advanced by the debtors and the creditors committee against permitting DSP to credit-bid its full debt.

He determined that DSP's liens did not extend to the transmission towers or to the proceeds from the sale of FCC licenses, and also found inequitable conduct on the part of DSP, stating that he was "troubled by DSP's efforts to frustrate the competitive bidding process."

As in Fisker Automotive, a ruling to limit credit bidding based on these findings alone would have been narrow and not noteworthy. But, just as Gross did in Fisker Automotive, Huennekens went further, and also found that "it is necessary to limit DSP from bidding the full amount of its claim against all of the debtors' assets in order to foster a fair and robust sale."

This last statement of Huennekens (if the decision stands on appeal), will be the focus of attention. In Free Lance-Star Publishing Co., as in Fisker Automotive, credit bidding could have been limited based solely on the basis of the asserted inequitable conduct.

Credit bidding can nearly always be said to "chill" competing offers. In one sense, that is its very purpose — to protect a secured creditor from being forced to accept a cash payment that is below that value the secured creditor believes the collateral possesses.

Given the extent to which Chapter 11 is used these days to effect sales of distressed businesses under Section 363 rather than reorganizations, and the common "loan-to-own" practice of purchasing secured debt at a discount for purposes of credit bidding, Huennekens' language is going to be cited in many objections to Section 363 sales.

Of course, the full impact of Fisker Automotive and Free Lance-Star Publishing Co. remains to be seen. The key question now is whether other courts will limit credit-bidding rights "for cause" in the absence of any inequitable conduct, but instead solely on the basis that it is necessary to "restore enthusiasm" among other potential bidders so as to improve the chances of a competitive auction. If a "loan-to-own" secured creditor acquired the debt and exercised its rights in good faith, will a court still limit its ability to credit-bid?

If so, then these cases will have a broad effect on both Chapter 11 and commercial law practice, and could significantly alter the secondary trading market for distressed debt. Another credit-bidding case is likely to make its way to the Supreme Court.

—By Benjamin D. Feder, Kelley Drye & Warren LLP

Ben Feder is special counsel in Kelley Drye's New York office.