

Third Circuit Court of Appeals Denies Secured Lender Right to Credit Bid in Auction of Collateral, Enhancing Ability of Equity Sponsors to Buy Assets in Bankruptcy

If a business is worth less than its secured obligations, a bankruptcy auction sale is often a means for recovering value for the secured lenders. In auction sales, a secured lender typically has the ability to “credit bid,” *i.e.*, to participate in the auction and to acquire collateral by bidding the amount of its secured debt. This important right protects the secured lender; a secured lender’s consent is effectively required for a sale of assets if the purchase price is less than the amount necessary to pay the secured lender in full.

In a recent decision, the U.S. Court of Appeals for the Third Circuit has weakened this protection, permitting a company in bankruptcy to accept a “stalking horse” bid by an insider and to establish bidding procedures that deny the secured lenders a right to credit bid at auction.

In *In re Philadelphia Newspapers, LLC*, the debtors signed an asset purchase agreement for sale of the company to a newly formed LLC that was majority owned by the controlling stockholders of the debtor. The asset purchase agreement provided for a cash purchase price of \$30 million, subject to higher or better offers, with a public auction to be conducted and a sale to the highest bidder to be consummated under a plan of reorganization. A consortium of secured lenders held \$318 million of secured debt. The reorganization plan provided for the secured lenders to receive the cash proceeds of the sale (\$30 million based on the stalking horse bid), \$7 million of the company’s cash, and real estate valued by the debtors at \$29.5 million. The debtors sought court approval of bidding procedures that would deny the secured lenders any right to credit bid, arguing that the cash price received from a well conducted auction would be the “indubitable equivalent” of the lenders’ secured claims.

While not deciding definitively that the secured lenders’ rights were protected or that the plan in this case could be confirmed, the Court of Appeals, in a 2 to 1 split decision, held that a secured lender does not have an absolute right to credit bid when its collateral is being sold pursuant to a plan of reorganization.

In addition, in a footnote, the Third Circuit noted that a broad exception exists to secured creditor rights to credit bid even in the context of bankruptcy sales conducted outside of a plan of reorganization, under Section 363 of the Bankruptcy Code. The court observed that, even in a Section 363 sale, “[a] court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment.”

The *Philadelphia Newspapers* case is an important decision limiting the rights of secured lenders to credit bid in asset sales in bankruptcy cases filed in Delaware, a jurisdiction where many important business bankruptcy cases are filed. The decision will also enhance opportunities for equity sponsors interested in acquiring companies out of bankruptcy. If you would like to learn more about the issues raised by the *Philadelphia Newspapers* decision, please contact your usual attorney at Ropes & Gray.