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Developments in Bankruptcy Asset Sales: Caution Ahead for Stalking Horses and Credit Bidders

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Two issues pertaining to asset sales in bankruptcy proceedings have recently come to the forefront: break-up fees and credit bidding. Recent court decisions sound caution for stalking horses, who often expect to be awarded break-up fees in the event that they are not the successful bidder in bankruptcy auctions, and for credit bidders, who often believe that they have a right to credit bid their debt in the sale of assets under both section 363 of the Bankruptcy Code and under a plan of reorganization.

Sales of Assets Outside the Ordinary Course in Bankruptcy

Generally in bankruptcy, a debtor may sell its assets outside of the ordinary course in two ways: (i) under section 363 of the United States Bankruptcy Code the ("Bankruptcy Code"), or (ii) pursuant to a plan of reorganization.

A sale of assets under section 363 of the Bankruptcy Code usually occurs by public auction. Typically, the initial bidder – the "stalking horse bidder" – with whom the debtor reaches an agreement for the sale of its assets, seeks certain protections to guard against the risk that another bidder will prevail at the auction, and to compensate the stalking horse for the expenses it has incurred in pursuing the transaction. Such protections will often include a floor for competing bids, reimbursement of expenses, and a break-up fee (typically, between 1%-3% of the stalking horse bidder's purchase price). These protections are not automatic – they must be approved by the bankruptcy court, as must the ultimately successful bidder at auction. In addition, section 363 of the Bankruptcy Code provides that a secured creditor may credit bid its claim, which ensures that the collateral is not sold for

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less than the face amount of the debt, and preserves the ability of the secured creditor to participate in any appreciation of the value of its collateral. In other words, the secured creditor uses the amount of its claim at an auction such that if the secured creditor is the winning bid, no exchange of money occurs and the amount of the bid is offset against the amount of the outstanding debt. Credit bidding protects the secured lender against attempts to sell the collateral too cheaply if the secured creditor thinks the collateral is worth more than the sale price.

Alternatively, a debtor can sell its assets pursuant to a plan of reorganization. The bankruptcy court must approve the plan before it is effective. A plan of reorganization can be approved over the objection of creditors, including a secured creditor, under the "cramdown" provisions of the Bankruptcy Code. To cramdown a secured creditor, among other things, the reorganization plan must be "fair and equitable" to the secured creditor. The "fair and equitable" standard may be satisfied by showing that the plan provides (1) that the holders of such claims retain the liens securing such claims and receive deferred cash payments having a present value equal to the value of their collateral; (2) for the sale of the collateral free and clear of liens (with such lien attaching to the sale proceeds of the sale) but subject to the secured creditor's right to credit bid (the "Sale Prong"); or (3) for the realization of the secured creditor's claim by some means which provides the secured creditor with the "indubitable equivalent" of its claim (the "Indubitable Equivalent Prong").

Break-Up Fees

After a recent decision by the influential Third Circuit Court of Appeals ("Third Circuit"), stalking horse bidders must be careful to structure and draft their bid documents in a way to best protect their ability to receive a break-up fee in the event that they are not the successful bidder. In In re Reliant Energy Channelview LP, the Third Circuit upheld the denial of a $15 million break-up fee to a stalking horse bidder because, inter alia, (i) the break-up fee was not conditioned upon court approval of the break-up fee, and (ii) the break-up fee was not found necessary to preserve the value of the estate.

In Reliant Energy, the debtor sought to sell substantially all of its assets. The debtor entered into an asset purchase agreement ("APA") with the stalking horse to sell the assets. The APA included a covenant that provided that if the bankruptcy court required an auction, the debtor would seek approval of a $15 million break-up fee and the reimbursement of the stalking horse's expenses of up to $2 million.

Pursuant to the APA, the debtor requested that the assets be sold without a public auction. After hearing the motion and an objection by a prior unsuccessful bidder, the court denied the debtor's request for the break-up fee. The court held that because the unsuccessful bidder had expressed its intent to bid for the assets, the break-up fee was not necessary to preserve the estate's value. The stalking horse chose not to participate at the court-ordered auction, and the initially unsuccessful bidder prevailed at auction.

The stalking horse bidder appealed the bankruptcy court decision, and the district court affirmed. On further appeal, the Third Circuit held that a break up fee may be awarded only when it induces the stalking horse bidder to make an initial bid or to

pursue the acquisition in the event of a court-ordered public auction. The Third Circuit held that the break-up fee was not necessary to induce the stalking horse to bid because the APA only required the debtor to seek approval of the break-up fee, not that the debtor actually obtain the court's approval of the break-up fee. The court held that the break-up fee was not necessary to preserve the stalking horse's bid because (i) the stalking horse was required to consummate the transaction regardless of whether the break-up fee was approved; (ii) the initially unsuccessful bidder indicated that the break-up fee was not necessary and that, in fact, it had a chilling effect on bidders; and (iii) the court's contention that the stalking horse would have closed the deal if it was the sole bidder.

Credit Bidding

On March 22, 2010, the Third Circuit issued a precedential decision in In re Philadelphia Newspapers LLC that significantly limits a secured lender's ability to credit bid its debt in the sale of assets pursuant to a plan of reorganization. The decision affirmed the District Court for the Eastern District of Pennsylvania's decision that authorized the debtors to require potential purchasers to submit all cash bids at the public auction for the debtors' assets under the plan, preventing the debtors' secured creditors from submitting a credit bid.

In Philadelphia Newspapers, the debtors, the publishers of several print and online publications, including the Philadelphia Inquirer, proposed a plan of reorganization that included a public auction for the sale of substantially all of the debtors' assets. As part of the sale, the debtors entered into an APA with Philly Papers, LLC, an investor group led by the management of the debtors and a stalking-horse bidder for the assets. The proposed plan of reorganization prohibited credit bidding and required all bids to be made in cash. The debtors argued, inter alia, that pursuant to the proposed plan the secured creditors would realize the indubitable equivalent of their claim thereby satisfying the Indubitable Equivalent Prong of the cramdown provisions. Further, the debtors argued, allowing the secured lenders to credit bid would chill competitive bidding at the auction, and thus, as a matter of policy, the lenders should be precluded from credit-bidding. The senior lenders, who are significantly under water, argued that under the cramdown provisions of the Bankruptcy Code, the secured creditors' right to credit bid is preserved and thus, they are entitled to credit bid their debt. The bankruptcy court agreed with the secured creditors finding that although the Bankruptcy Code's cramdown provisions are ambiguous, the legislative history reflects the legislators' intent that a secured creditor should have the right to credit bid its debt under either section 363 or a sale of assets pursuant to a plan of reorganization.

The debtors appealed, and the district court reversed, finding that the cramdown provisions of the Bankruptcy Code clearly provide that a debtor need only satisfy only one of the three prongs of the "fair and reasonable" standard. In this case, the district court found that the debtors intended to satisfy the Indubitable Equivalent Prong, which does not explicitly provide a secured creditor with a right to credit bid. Notably, the district court did not decide whether the debtors' proposed plan actually satisfied the Indubitable Equivalent Prong. Rather, the district court's holding was that under a plain reading of the Indubitable Equivalent Prong, a secured lender does not have a right to credit bid. The secured creditors appealed, but the Third Circuit affirmed the district court's finding that the Bankruptcy Code unambiguously permits a debtor to proceed with any plan that provides secured

lenders with the "indubitable equivalent" of their secured interest in the assets and contains no statutory right to credit bidding. Again, the court refrained from answering the question as to whether the auction can generate the indubitable equivalent of the lenders' secured interest in the debtors' assets. This decision effectively strips away significant safeguards that allow secured creditors to collect on their collateral in the context of a sale pursuant to a plan of reorganization.

Practical Considerations

The Reliant Energy and Philadelphia Newspapers cases have significant implications. First, Reliant Energy teaches that in order to maximize the stalking horse bidder's chances of recovering a break-up fee, the APA should explicitly provide that the stalking horse bidder shall have the right to terminate the APA if the bankruptcy court does not approve the break-up fee, and that the break-up fee induced the stalking horse bidder to bid. Second, Philadelphia Newspapers holds that a secured creditor does not have a statutory right to credit bid its debt in a sale under a plan of reorganization. ■

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