Secured Lenders Do Not Have an Absolute Right to Credit Bid at Bankruptcy Plan Sales

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Introduction

In a decision that could have wide ranging consequences for secured lenders and the distressed debt market, a divided U.S. Court of Appeals for the Third Circuit has held that secured creditors do not have an absolute right to credit bid the value of their loans in chapter 11 plan-based sales of assets. The case, In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. Mar. 22, 2010), follows on the heels of a similarly decided ruling by the Fifth Circuit in Bank of New York Trust Co., NA v. Official Unsecured Creditors' Committee (In re Pacific Lumber Co.), 584 F.3d 229 (5th Cir. 2009). Both Courts held that notwithstanding Bankruptcy Code section 1129(b)(2)(A)(ii), which permits secured creditors the right to credit bid under a plan-based sale, a plan may alternatively permit the sale of the creditor's collateral under subsection 1129(b)(2)(A)(iii) without credit bidding protection if the secured creditor receives the "indubitable equivalent" of its claim under the plan. These are the only published circuit court decisions addressing this issue, and thus, absent a contrary ruling by the U.S. Supreme Court or revision of the Bankruptcy Code by Congress, these cases may have an impact not only within the Third and Fifth Circuits but throughout the United States. In fact, anecdotal evidence suggests that secured creditors are already seeking entry of cash collateral orders that require any plan-based sale to be conducted under subsection 1129(b)(2)(A)(ii) rather than subsection (iii). The extent to which such orders are enforceable and curative of the secured creditors' concerns remains to be seen.

The Significance of Credit Bidding

The ability of a secured creditor to credit bid its total loan amount at auction and to "buy" its collateral is an important and well-recognized tool in a secured creditor's toolbox. This remedy is typically viewed as a trump card available to a secured creditor to protect itself from an insufficient bid. Credit bidding is also an oft-cited rationale and exit strategy for distressed investing -- an investor may acquire a distressed loan with the primary goal of foreclosing outside of bankruptcy or by acquiring the assets through credit bidding in bankruptcy. While credit bidding outside of a plan under Bankruptcy Code section 363(k) has always been subject to possible limitations or restrictions based upon "cause," the Philadelphia Newspapers and Pacific Lumber decisions weigh into an issue that has divided bankruptcy courts: whether a plan-based sale (as opposed to a section 363 sale) may be structured to prevent a secured creditor from credit bidding on its collateral. The answer, at least within the Fifth and Third Circuits, is yes.

Case Background and the Lower Court Rulings

Philadelphia Newspapers, LLC and its related entities ("Philadelphia Newspapers") own and operate publications including the *Philadelphia Inquirer* and the *Philadelphia Daily News*. These assets were acquired in July 2006 for $515 million, $295 million of which came from a consortium of lenders (the "Lenders") who were given a first priority lien in substantially all of Philadelphia Newspapers' real and personal property. After workout negotiations with the Lenders fell apart, Philadelphia Newspapers filed their chapter 11 bankruptcy cases in February 2009. In August 2009, the debtors filed a joint chapter 11

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plan that proposed a sale of substantially all assets free and clear of liens at a public auction. Simultaneously, the debtors signed an asset purchase agreement with a stalking horse bidder. Equity owners and former equity owners of Philadelphia Newspapers held a majority ownership interest in the stalking horse. Under the proposed plan, the asset sale would generate $37 million in cash for the Lenders and the Lenders would receive Philadelphia Newspapers' headquarters subject to a two year, rent-free lease to the entity that operates the newspapers. The plan also proposed that the Lenders receive any cash generated by a higher bid at the public auction.

The debtors sought to preclude the Lenders from credit bidding at the auction sale in the bidding procedures motion. This provision was objected to by the Lenders, the Unsecured Creditors' Committee, the Office of the U.S. Trustee, and the Pension Benefit Guaranty Corporation, among others. The bankruptcy court upheld the Lenders' objection, entered an order permitting the Lenders to credit bid, and subsequently entered an order approving revised bid procedures that specifically allowed the Lenders to bid the full value of their secured debt as of the petition date. This ruling was appealed to the district court.

The district court reversed the bankruptcy court. In doing so, the district court relied on what it viewed as the plain language of Bankruptcy Code section 1129(b)(2)(A), and held that the Lenders were not entitled to credit bid if the proposed sale was being conducted under subsection (iii) rather than (ii). The district court further ruled that because the plan proposed to give the Lenders the "indubitable equivalent" of their secured interest, the treatment of the Lenders' claims was "fair and equitable" for purposes of confirmation. The Lenders appealed the district court's ruling to the Third Circuit.

The Third Circuit Upholds the Extinguishment of the Right to Credit Bid in a Plan Sale

The Third Circuit affirmed the district court.

The court began its analysis by looking at the language of the Bankruptcy Code, specifically section 1123(b)(2). After noting that the "plan sale" authorized by section 1123(a)(5)(D) does not contain explicit procedures for the sale of assets that secure debts of the bankruptcy estate, the court looked to the language of the Bankruptcy Code section 1129(b) to determine what requirements would have to be satisfied in order to confirm a plan, including a plan providing for an asset sale. In particular the court looked to the standard that must be met for a plan to be found fair and equitable to secured creditors under section 1129(b)(2)(A).

Section 1129(b)(2)(A) provides that with respect to a class of secured claims, a plan must provide:

(i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the

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allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of [the Bankruptcy Code], of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

11 U.S.C. § 1129(b)(2)(A).

The Court recognized that a sale conducted under subsection 1129(b)(A)(2)(ii) provides secured creditors with the right to credit bid by reference to section 363(k). The court focused on the disjunctive "or" in the statute, and held that this use of the disjunctive operates to provide alternatives. Thus, a debtor may conduct a sale under subsection (ii), which provides for a credit bid, but also subsection (iii), which does not provide for credit bidding but rather requires that the secured creditor receives the indubitable equivalent of its claims.

The Lenders, relying on a traditional canon of statutory interpretation -- that the specific term prevails over the general -- argued that a plan calling for a sale of assets free and clear of liens must comply with the requirements of subsection (ii) and include a secured creditor's right to credit bid; that is, a plan sale cannot also be conducted under subsection (iii). The court rejected this argument as applicable only if the specificity of subsection (ii) operates as a limitation on the broader language in subsection (iii), which the court found not to be the case. According to the Third Circuit, Congress' inclusion of the indubitable equivalence option intentionally left open the potential for other methods of conducting asset sales, so long as those methods sufficiently protected the secured creditor's interests.

After holding that section 1129(b)(2)(A)(iii) excludes a secured creditor's right to credit bid, the court discussed the meaning of "indubitable equivalence." The court found that indubitable equivalence in this instance means "the unquestionable value of a lender's secured interest in the collateral." That is, the scope of indubitable equivalence under section 1129(b)(2)(A)(iii) is circumscribed by the same principle that underlies subsections (i) and (ii) -- the protection of a fair return to secured lenders. The Third Circuit also recognized that a debtor may give a secured lender the indubitable equivalent of its claim in different ways, including through a cash payout, the exchange of collateral, abandonment of the collateral to the secured creditor, and a replacement lien on similar collateral. The court noted that even though section 1129(b)(2)(A)(iii) excludes a secured creditor's right to credit bid, the secured creditor may argue that the restriction on credit bidding failed to generate fair market value at the auction sale and thereby prevented the secured creditor from receiving the indubitable equivalent of its claim.

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The Dissent

Third Circuit Judge Ambro, a former bankruptcy practitioner, wrote a lengthy dissenting opinion in which he disagreed with the majority's fundamental conclusion that section 1129(b)(2)(A) is unambiguous. Judge Ambro opined that section 1129(b)(2)(A) is ambiguous and is susceptible to more than one reasonable reading. As such, it must be interpreted in context of the entire Bankruptcy Code, the legislative history, "and the comments of Code drafters." Judge Ambro concluded that consideration of all of these sources leads to the conclusion that the Bankruptcy Code requires cramdown plan sales free of liens to fall under subsection section 1129(b)(2)(A)(ii) rather than under the "general" requirement of subsection (iii). Judge Ambro's dissent also addressed the right to credit bid in the context of the broader market. According to Judge Ambro, secured creditors have lawfully bargained pre-bankruptcy for unequal treatment and the right to credit bid is an important "consequence" of this lawful bargaining. In his view, the majority opinion increases the potential for a secured creditor to lose its right to credit bid and thus potentially "uproots settled expectations." Judge Ambro finally predicts that this will result in secured creditors adjusting their pricing to account for the new risks -- potentially raising interest rates or reducing credit availability.

The Import of these Decisions

The Philadelphia Newspapers decision follows closely on the heels of the Fifth Circuit's decision in Pacific Lumber. Based on very similar analysis, the Fifth Circuit held that a plan involving a sale of noteholders' collateral free and clear of their liens, but which denied the noteholders the right to credit bid, could be confirmed under the indubitable equivalent prong of section 1129(b)(2)(A)(iii). Additionally, while not having the same wide-ranging effects as the Philadelphia Newspapers and Pacific Lumber cases, the U.S. Bankruptcy Court for the District of Maryland had previously issued an opinion holding that a plan providing for an asset sale could be confirmable under section 1129(b)(2)(A)(iii) even if it does not afford a secured creditor the right to credit bid the value of its loan on the auction sale of its collateral. In re Criimi Mae, Inc., 251 B.R. 796 (Bankr. D. Md. 2000).

These decisions make it the law of the land -- at least within the Third and Fifth Circuits -- that an asset sale under a bankruptcy plan need not provide a secured creditor with the right to credit bid its claim. Importantly, these courts are well-respected and their decisions will be influential to other courts deciding whether to confirm chapter 11 plans proposing asset sales and simultaneously restricting the secured creditors' rights to credit bid.

These decisions are important; in fact, they may be game changers in many bankruptcy cases and could affect investment decisions and interests in the distressed debt market. In bankruptcy cases, these decisions will shift some power (at least in the Fifth and Third Circuits) from secured creditors to debtors and other parties by denying secured creditors the presumptive right to credit bid in certain plan-based sales. These cases may encourage other bidders who might otherwise have opted not to bid against a secured creditor and will undoubtedly lead to disputes and a new body of decisions on what does

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and does not constitute indubitable equivalence. All of this appears to give debtors leverage to restructure and/or cram down secured debt.

Secured creditors also may seek to fight back, for example, by restricting or conditioning the use of cash collateral or other assets to better protect their position. Anecdotal evidence from recent Chapter 11 cases suggests that sophisticated secured lenders are already seeking to do so in bankruptcy courts within the Third Circuit. Secured creditors may seek to force debtors to sell assets early in cases under a section 363 sale rather than waiting for the plan confirmation process because, although section 363 recognizes limitations on credit bidding "for cause," the "for cause" limitation may be more difficult for a debtor to establish than establishing indubitable equivalence during plan confirmation. Also, these rulings may affect the distressed debt market well beyond the Fifth and Third Circuits in the ways Judge Ambro contemplated -- by causing buyers of distressed secured debt to rethink pricing and exit options. Those who buy secured debt with a goal of acquiring the underlying assets or company should be particularly mindful of these added risks.

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