

Insolvency and Restructuring Update

In re Philadelphia Newspapers, LLC:

Third Circuit Court of Appeals Denies Secured Creditors' Right to Credit Bid in Sale Pursuant to a Plan of Reorganization

In a much anticipated decision, on March 22, 2010, a split panel of the United States Court of Appeals for the Third Circuit affirmed a District Court decision holding that a debtor may bar its secured creditors from credit bidding at a sale of substantially all of the debtor's assets conducted pursuant to a chapter 11 plan of reorganization.

In *In re Philadelphia Newspapers, LLC*,¹ the Third Circuit approved bid procedures proposed by the debtors that did not permit holders of liens on the debtors' assets to credit bid in an auction of those assets. The Court, in construing section 1129(b) of the Bankruptcy Code, held that "subsection (iii) of Section 1129(b)(2)(A) 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" ² The Court also emphasized that the plan of reorganization must subsequently and separately meet the "fair and equitable" standard articulated in section 1129(b)(2)(A) of the Bankruptcy Code, which governs the cramdown of secured creditors.

Judge Thomas L. Ambro issued a lengthy dissenting opinion, rejecting the majority's conclusion that the plain meaning of the statute required the result reached, and concluding that the Bankruptcy Code grants secured creditors the right to credit bid in chapter 11 plan sales.

Background

Credit bidding allows a secured creditor to bid the amount owed to it in certain sales of property of a debtor's estate. The purpose of credit bidding is to permit secured creditors to obtain possession of their collateral rather than receive the proceeds of a sale for consideration that they view as inadequate. Sales of property of the estate outside of the ordinary course of the debtor's business may be conducted pursuant to section 363(b) of the Bankruptcy Code or pursuant to a plan of reorganization. Section 363(k) expressly authorizes credit bidding in sales conducted pursuant to section 363(b); the Third Circuit addressed whether a similar right exists when a secured creditor's collateral is sold pursuant to a plan.

To be confirmed, a plan of reorganization that has not been accepted by a class of claimants entitled to vote on such plan must demonstrate, among other things, that the plan is "fair and equitable" with respect to such dissenting class. Section 1129(b)(2)(A) of the Bankruptcy Code sets forth three methods by which a plan may be deemed "fair and equitable" with respect to a class of secured claims. Under subsection (i), the holders of secured claims can retain the liens securing their allowed claims and receive deferred payments having a present value equal to the value of their collateral; under (ii), the collateral can be sold free and clear of the liens, with the liens attaching to the proceeds of such sale, so long as

¹ *In re Phila. Newspapers, LLC*, Case No. 09-4266 (3d Cir. Mar. 22, 2010).

² *Id.* at 5.

the secured creditor is permitted to credit bid; and under (iii), the plan can provide for the secured creditors to receive the “indubitable equivalent” of their secured claims (generally meaning substituted value such that the secured creditor receives the benefit of its bargain). The majority and the dissent differed on whether an auction can take place under (iii), without the protections of (ii).

In re Philadelphia Newspapers, LLC

In *In re Philadelphia Newspapers, LLC*,³ the debtors sought to require that any qualified bidder in an auction for substantially all of the debtors’ assets to be conducted pursuant to a plan of reorganization fund its purchase offer with only cash – thereby seeking to preclude secured creditors from credit bidding. The “stalking horse bidder,” with whom the debtors had entered into an Asset Purchase Agreement prior to the filing of the plan, was an investor group led by the debtors’ current management. The steering group of the debtors’ pre-petition secured lenders (which had long made it known that it intended to place a credit bid) and the agent for the pre-petition secured lenders objected to the requirement precluding credit bidding.

Decisions of the Lower Courts

Chief Judge Stephen Raslavich of the U.S. Bankruptcy Court for the Eastern District of Pennsylvania rejected the debtors’ argument that they could deny their secured lenders the opportunity to credit bid. The Bankruptcy Court agreed with the secured lenders that “the intent of the integrated provisions of the Bankruptcy Code (§§ 363, 111, 1123, and 1129) is to ensure that where an undersecured creditor’s collateral is proposed to be sold, whether under § 363 or under a plan, the secured creditor is entitled in all events to protect its rights to its collateral, either by making an election under § 1111(b) or by credit bidding its debt.”⁴ The Bankruptcy Court rejected the theory that the disjunctive nature of section 1129(b)(2)(A) of the Bankruptcy Code allowed a debtor to preclude credit bidding so long as the plan was “fair and equitable” under any of its alternative tests.

The District Court reversed the Bankruptcy Court’s decision, holding that the debtors could prohibit the use of credit bids at the auction.⁵ Applying the “plain meaning” rule of statutory construction and referring to the Fifth Circuit’s recent decision in *Pacific Lumber*,⁶ the District Court explained that, in enacting section 1129(b)(2)(A) of the Bankruptcy Code, Congress appears to have provided chapter 11 debtors with three alternative paths to cramdown, one of which (section 1129(b)(2)(A)(iii)) does not entitle a secured creditor to credit bid. The District Court concluded that, in seeking to cram down the dissenting secured creditors, the debtors were not limited to utilizing section 1129(b)(2)(A)(ii), the “Sale Prong,” which entitles secured creditors to credit bid. The District Court concluded that the sale of a secured creditor’s collateral pursuant to a plan of reorganization was allowed as long as the secured creditor receives the “indubitable equivalent” of its claim.

The Court of Appeals’ Opinion

The Court of Appeals for the Third Circuit affirmed the District Court, concluding that the plain language of the Bankruptcy Code allowed the debtors to preclude credit bids in a sale pursuant to a plan of reorganization. In so deciding, the Court found that subsection (ii) of section 1129(b)(2)(A) was not the

³ *In re Phila. Newspapers, LLC*, Case No. 09-11204 (SR, CJ), [Dkt. No. 1234] (Bankr. E.D. Pa. Oct. 8, 2009).

⁴ *Id.* at 10.

⁵ *In re Phila. Newspapers, LLC*, 418 B.R. 548 (E.D. Pa. 2009).

⁶ *Bank of N.Y. Trust Co., NA v. Official Unsecured Creditors’ Comm. (In re Pacific Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009).

exclusive means for conducting a “fair and equitable” plan sale of assets free and clear of liens, but that such a sale pursuant to subsection (iii), which, unlike subsection (ii), does not expressly permit credit bidding, was also permissible.

Examining the plain meaning of the statute, the Court found that section 1129(b)(2)(A) was disjunctive and unambiguous on its face and permitted “a debtor to conduct an asset sale under subsection (iii) without allowing secured lenders to credit bid.”⁷ The Court determined that although subsection (ii) “may reflect ‘a special congressional concern’ about the free and clear transfer of collateral that secures a loan . . . it is apparent here that Congress’ inclusion of the indubitable equivalence prong intentionally left open the potential for yet other methods of conducting asset sales, so long as those methods sufficiently protected the secured creditor’s interests.”⁸

While the Court’s opinion makes clear that when seeking to cram down secured creditors in an asset sale pursuant to a plan of reorganization, a debtor may preclude credit bids and proceed under subsection (iii) by granting secured creditors the “indubitable equivalent” of their claims, the Court also recognized that the bankruptcy court must find the plan “fair and equitable” under section 1129(b)(2)(A). With this limitation in mind, the Third Circuit highlighted the prematurity of drawing any conclusions with respect to the “fair and equitable” requirement to plan confirmation. Rejecting the dissent’s contention that allowing a free and clear sale of assets under the “indubitable equivalent” prong would deny secured lenders the “fair and equitable” treatment to which they are entitled under subsection (ii), the Court reasoned that a determination regarding whether the plan is “fair and equitable” under section 1129(b)(2) “is a question for plan confirmation and cannot be answered at this stage by manufacturing extratextual statutory constraints.”⁹ Therefore, the Court was “simply not in a position at this stage to conclude, as a matter of law, that this auction cannot generate the indubitable equivalent of the Lenders’ secured interest in the Debtors’ assets.”¹⁰ The Court indicated that while the debtors may preclude credit bidding at an auction of their assets, the Lenders may argue at confirmation that the plan did not generate the “indubitable equivalent” of their claims and, therefore, is not “fair and equitable” and should not be confirmed.

Judge Ambro’s Dissent

In a lengthy dissent, Judge Ambro opined that 1129(b)(2)(A) is indeed ambiguous and therefore “more than one reasonable reading of the statute” is permissible.¹¹ He reasoned that the issue must be considered with respect to “long-established canons of statutory interpretation to § 1129(b)(2)(A), . . . the context of the entire Bankruptcy Code [as well as] the section’s legislative history and the comments of the Code drafters[.]”¹² He concluded that the Bankruptcy Code requires that chapter 11 asset sales free and clear of liens be subject to the specific requirements of section 1129(b)(2)(A)(ii) instead of the general requirement of subsection (iii), thus mandating that secured creditors be allowed to credit bid the value of their collateral.

Judge Ambro’s dissent also focused on the practical consequences of the Court’s decision in this case (and the arguably unsavory facts), noting that “debtors generally would pursue confirmation under clause (ii) only if they somehow concluded that providing a right to credit bid as required by that clause would be

⁷ *In re Phila. Newspapers, LLC*, Case No. 09-4266 at 12 (3d Cir. Mar. 22, 2010).

⁸ *Id.* at 21-22 (internal citations omitted).

⁹ *Id.* at 23 n.8 (internal citations omitted).

¹⁰ *Id.* at 32-33.

¹¹ *In re Phila. Newspapers, LLC*, Case No. 09-4266 at 1 (Ambro, J., dissenting) (3d Cir. Mar. 22, 2010).

¹² *Id.*

more advantageous to them than denying that right.”¹³ Precluding secured creditors from credit bidding, the dissent observed, denies them the benefit of their pre-petition bargain and is “contrary to the settled expectations of debtors and lenders bargaining in the shadow of the Bankruptcy Code.”¹⁴

Future Implications

The Court of Appeals’ holding deals an unwelcome blow to secured creditors. It opens the door to debtors evading statutory credit bidding rights by proposing auctions under plans of reorganization that bar credit bidding.¹⁵ Whether courts in other circuits will follow the decision remains to be seen.

The secured lenders’ rights in *Philadelphia Newspapers* have not, however, yet been definitely extinguished. As the majority noted, “our holding here only precludes a lender from asserting that it has an absolute right to credit bid when its collateral is being sold pursuant to a plan of reorganization . . . in some instances, credit bidding may be required . . . [and] a lender can still object to plan confirmation on a variety of bases, including that the absence of a credit bid did not provide it with the ‘indubitable equivalent’ of its collateral.”¹⁶ Where a secured creditor is precluded from credit bidding its collateral, it will still retain the right to object to confirmation of the reorganization plan under the argument that the plan is not “fair and equitable.” Nevertheless, the decision makes it more likely that some debtors that have an incentive or reason to be averse to the prospect of secured lenders receiving their collateral will attempt to effectuate asset sales through the longer and more expensive plan of reorganization route rather than pursuant to section 363(b) of the Bankruptcy Code.



[Please click here for a copy of the opinion.](#)

¹³ *Id.* at 43.

¹⁴ *Id.*

¹⁵ As Judge Ambro observed in his dissent, the majority’s decision may force “future secured creditors to adjust their pricing accordingly, potentially raising interest rates or reducing credit availability to account for the possibility of a sale without credit bidding.” *Id.* at 46. Without assurance of the right to credit bid their collateral at a chapter 11 sale, secured creditors may be more reluctant to lend to distressed companies, thereby increasing the cost of credit for such businesses.

¹⁶ *In re Phila. Newspapers, LLC*, Case No. 09-4266 at 43-44 (3d Cir. Mar. 22, 2010) (internal citations omitted).

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