Credit Bidding in a Sale Under a Plan Is Not a Right:
The Third Circuit's *Philadelphia Newspapers* Decision

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Secured lenders are not as protected in bankruptcy as they might have thought, at least in the Third Circuit. In *In re Philadelphia Newspapers, LLC*, the court of appeals sent shock waves through the commercial lending industry by ruling that a dissenting class of secured creditors can be stripped of any right to credit-bid its claims under a chapter 11 plan that proposes an auction sale of the creditors' collateral free and clear of liens. The highly anticipated decision is clearly not the result that secured lenders had hoped for, and the ruling has left lenders scrambling to devise new strategies to protect themselves in chapter 11 cases.

The Debtors

Philadelphia Newspapers LLC and its affiliates (the "Debtors") own and operate the local newspapers *The Philadelphia Inquirer* and the *Philadelphia Daily News*, as well as the online publication philly.com. Their financing came mainly through a $295 million senior secured credit facility entered into with various lenders (collectively, the "Lender Group"). Due to the tribulations of the newspaper business as a whole, the Debtors were forced to file for protection under chapter 11 of the Bankruptcy Code on February 22, 2009, in Philadelphia.

The Plan Sale

The Debtors filed their chapter 11 plan on August 20, 2009. Under the plan, substantially all of the assets of the Debtors would be sold free and clear of liens pursuant to an auction, with the proceeds of the auction, less a carve-out for certain expenses, passing to the Lender Group. The Debtors' proposed bidding procedures for the auction incorporated a "stalking horse" bid for the assets from a consortium consisting of existing equity holders who controlled approximately 50

percent of the outstanding equity interests in the Debtors. This bid would provide $37 million in cash for the Lender Group, which, along with certain additional distributions of property, would result in a recovery by the Lender Group of approximately $66.5 million on account of their secured claim of more than $300 million.

The Lender Group publicly noted that it believed the stalking-horse bid was too low, and it announced its intention to "credit-bid" at the auction, setting off any amount bid for the assets against amounts the Debtors owed the Lender Group under the secured credit facility, which was secured by those same assets. The Debtors filed a motion to approve the proposed bidding procedures on August 28, 2009. Notably, the proposed bidding procedures required that bids must be all-cash, prohibiting the Lender Group from credit bidding at the auction. The Lender Group objected to the proposed bidding procedures, arguing that the Bankruptcy Code requires that a secured lender be permitted to credit-bid at a sale of its collateral as part of a chapter 11 plan.

The "Fair and Equitable" Test

The Lender Group argued that the plain meaning of section 1129(b) of the Bankruptcy Code, which sets forth the requirements for a "cramdown" chapter 11 plan, precludes the Debtors from conducting a sale of collateral free of liens under a plan without affording the secured party the right to credit-bid. Section 1129(b)(1) requires, among other things, that in order to be confirmed over the dissent of a class of creditors or interest holders, the plan must be "fair and equitable" with respect to the dissenting class. Section 1129(b)(2) addresses the "fair and equitable" requirement for different types of claims. Section 1129(b)(2)(A) provides three alternative ways to achieve confirmation over the objection of a dissenting class of secured claims: (i) the secured

claimant's retention of its liens and receipt of deferred cash payments equal to the value, as of the plan effective date, of its secured claim; (ii) the sale, "subject to section 363(k)," of the collateral free and clear of all liens, with attachment of the liens to the proceeds and treatment of the liens under option (i) or (iii); or (iii) the realization by the secured creditor of the "indubitable equivalent" of its claim.

The Lender Group argued that this structure makes clear that all sales of collateral free of liens under a chapter 11 plan fall under section 1129(b)(2)(A)(ii), and thus, a secured creditor always has the right to credit-bid in such a sale, unless its class consents to the plan. The Debtors countered that the "fair and equitable" requirements are set in the disjunctive, such that so long as the Lender Group realizes the "indubitable equivalent" of its secured claims, it need not be afforded the right to credit-bid in the sale.

Collateral Valuation and the Section 1111(b) Election

The Lender Group further argued that the Bankruptcy Code's protections for secured claimants militate in favor of a right to credit-bid in any sale, either during the course of the bankruptcy or as part of the chapter 11 plan. In particular, section 1111(b) provides that a secured creditor with recourse against a debtor on account of a secured claim can elect to have its entire claim treated as secured, rather than bifurcated into a secured claim to the extent of the value of the collateral and an unsecured claim for the deficiency. However, section 1111(b) provides that the election is not available if the collateral is sold under section 363 of the Bankruptcy Code or under a chapter 11 plan.

Section 1111(b) is intended to protect a secured creditor against the possibility that the debtor can realize a windfall if collateral is assigned a low value (due to depressed market conditions or valuation error) and the creditor's secured claim is stripped down to the depressed value of its security interest. The exception for collateral that is sold is premised upon the idea that protection against low valuation is not necessary when the market determines the value of the collateral. In *Philadelphia Newspapers*, the Lender Group argued that section 363(k), which allows a secured claimant to credit-bid, is an essential part of a secured creditor's protection because it ensures that the secured creditor is satisfied with the sale price (otherwise it would outbid, using the value of its secured claim, and simply take the collateral).

According to the Debtors, Congress could have explicitly made all sales of collateral free of liens under a plan subject to a secured creditor's right to credit-bid, but it failed to do so. Also, the Debtors claimed, allowing the Lender Group to credit-bid might drive away other potential bidders, who would be reluctant to engage in the diligence necessary to make a bid because the Lender Group could simply outbid them at no actual cost. Thus, the Debtors argued, any right of the Lender Group to credit-bid could actually allow the Lender Group to acquire the company or its assets for an inadequate price.

Chief bankruptcy judge Stephen Raslavich refused to allow the Debtors' assets to be sold without affording the Lender Group the right to credit-bid its claims. The court held that the more reasonable interpretation of the "fair and equitable" test for treatment of secured creditors is that the requirement in section 1129(b)(2)(A)(ii) for a sale under a plan to be "subject to" a secured creditor's right to credit-bid applies to all sales under a plan. Section 1129(b)(2)(A)(iii),

the court reasoned, is implicated only when a plan provides for the abandonment of collateral to secured creditors or the substitution of collateral.

According to the bankruptcy court, credit bidding is designed to protect against low-ball judicial valuation of collateral. The court rejected the Debtors' argument that allowing credit bidding could actually chill the bidding process, reasoning that, because recoveries to all claimants other than the Lender Group were fixed, the existence of any higher bid would affect only the Lender Group's returns. As the Lender Group wanted to credit-bid, the court declined to second-guess it as to the course of action that would provide it with the greatest recovery.

The district court reversed on appeal, approving the bidding procedures. Among other things, it reasoned that the plain meaning of section 1129(b)(2)(A), particularly the use of the disjunctive "or," indicates that the three tests for satisfying the "fair and equitable" test are alternatives. Moreover, the district court emphasized, nothing in section 1129(b)(2)(A) links the requirements for "fair and equitable" treatment under a plan to the ability of a secured claimant to make a section 1111(b) election.

The Third Circuit's Ruling

A divided panel of the Third Circuit affirmed the district court's ruling on appeal. The court of appeals reiterated the district court's reliance on the importance of the plain-meaning rule and the use of the disjunctive "or" in section 1129(b)(2)(A). According to the majority ruling, the "indubitable equivalent" prong—section 1129(b)(2)(A)(iii)—does not itself require that a secured creditor be permitted to credit-bid its claim. Instead, the court held, the "indubitable equivalent" alternative unambiguously requires a secured creditor to realize "the unquestionable

value” of the creditor’s secured interest in the collateral. The Lender Group argued that, under existing Third Circuit precedent, the amount of a secured creditor’s successful credit bid for its collateral determines the value of that collateral, and thus, assuring the realization of the “indubitable equivalent” of a secured claim requires affording secured creditors the right to credit-bid for their collateral. Under this reasoning, even if the “indubitable equivalent” test could be utilized, the right to credit-bid would still be required. The majority of the Third Circuit panel disagreed, holding that the value of the collateral could be determined in other ways. It refused to conclude as a matter of law that the auction could not possibly allow the Lender Group to realize the “indubitable equivalent” of its secured claims. Whether the results of the auction in fact satisfy this test, the court explained, remains open for dispute at the plan confirmation stage.

In rejecting the Lender Group’s argument that section 1129(b)(2)(A) should be read in conjunction with section 1111(b), the majority opinion held that Congress did not intend secured creditors to have the right to credit-bid whenever their collateral is sold under a plan, because the right to credit-bid is not absolute. In particular, the court explained that a sale of collateral can occur in bankruptcy without allowing the secured creditor to credit-bid when: (i) the court orders that a credit bid should be disallowed “for cause” under section 363(k) itself; or (ii) the collateral is sold subject to the lien under section 1129(b)(2)(A)(i), in which case the future payments required to be made to the secured creditors must have a present value equal only to the judicial valuation of the security interest in the collateral. Thus, the court reasoned, there is no overarching scheme in the Bankruptcy Code to protect the value of secured claims by means of the right to credit-bid.

Judge Thomas L. Ambro, a former bankruptcy practitioner, wrote a vigorous 48-page dissent. Judge Ambro opined that section 1129(b)(2)(A) can reasonably be read as outlining the different requirements to satisfy the "fair and equitable" test, but that only one of the three requirements is applicable to any given class of secured creditors under a plan. The applicable requirement is determined by the treatment of the class of secured creditors. In addition, Judge Ambro would have applied the context of section 1111(b) and the legislative history of the provisions to conclude that "the Code requires cramdown plan sales free of liens to fall under the specific requirements of § 1129(b)(2)(A)(ii) and not to the general requirement of subsection (iii)." Finally, the judge observed that the panel's ruling would not prevent the bankruptcy court from finding "that the debtors' plan is a thinly veiled way for insiders to retain control of an insolvent company minus the debt burden the insiders incurred in the first place." A bankruptcy judge, he remarked, could also rule that the plan is not "fair and equitable."

The Aftermath

Philadelphia Newspapers is admittedly a setback for secured creditors relying on the protection of credit bidding in bankruptcy. According to some observers, the ruling may encourage debtors, unsecured creditors, and other stakeholders whose interests are not aligned with those of secured creditors to propose plans that provide for sales of lender collateral without honoring secured creditors' credit-bidding rights. A debtor or a creditors' committee, for example, might threaten to propose a cramdown plan that denies credit-bidding rights as leverage in order to obtain concessions from senior lenders during the plan negotiation process. On the flip side, lenders may be inclined to insist early on in a chapter 11 case (*i.e.*, in connection with DIP financing or

cash collateral agreements) that sales be conducted through stand-alone auctions under section 363(b) with credit-bidding rights.

The events that have transpired in the *Philadelphia Newspapers* bankruptcy since the Third Circuit issued its opinion illustrate how secured creditors may be able to work around the decision. The Lender Group petitioned the Third Circuit for rehearing en banc, but the petition was summarily denied, with only Judge Ambro stating that he would have granted rehearing.

However, on April 28, 2010, the Lender Group prevailed in the auction held pursuant to the bidding procedures approved by the Third Circuit, purchasing substantially all of the Debtors' assets for approximately $138.9 million. In order to make such a bid, the Lender Group was required to obtain financing to pay this amount in cash. But because the bidding procedures provide that any extra cash generated by the auction must flow back to the Lender Group, the Lender Group will recover much of this purchase price under the plan.

The ultimate result in *Philadelphia Newspapers* raises the question of just how important the right to credit-bid actually is. The answer should not be oversimplified. For instance, credit documents may allow the entire amount of a syndicated secured lending facility to be credit-bid at the direction of a majority or supermajority of the lenders, despite the dissent of other lenders. In such a case, the credit documents generally would not require minority lenders to contribute additional funds for such a bid. Thus, if there is no right to credit-bid in a sale under a plan, the lending syndicate may not be able to raise the funds necessary to purchase the collateral with

cash and achieve the same result. This means that the right to credit-bid may be essential to overcome collective-action difficulties in some circumstances.

Philadelphia Newspapers comes closely on the heels of the September 2009 ruling in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009), in which the Fifth Circuit similarly considered whether section 1129(b)(2)(A)(ii) is the only avenue to confirmation of a plan under which the collateral securing the claims of a dissenting secured class is to be sold. The court of appeals ruled that section 1129(b)(2)(A)(ii) does not always provide the exclusive means by which to confirm a reorganization plan where the sale of a secured party's collateral is contemplated. Rather, the Fifth Circuit held that, where sale proceeds provide a secured creditor with the indubitable equivalent of its collateral, confirmation of a plan is possible under section 1129(b)(2)(A)(iii). In addition, consistent with its conclusion that the sale transaction in the chapter 11 plan accomplished that result, the court rejected an argument by noteholders that confirmation was improper because they had not been afforded the opportunity to credit-bid their claims for the assets.

It remains to be seen how other courts will come down on this important issue, but at present the momentum appears to be in favor of allowing plan proponents to limit secured creditors' rights to credit-bid in a sale of their collateral under a chapter 11 plan.

In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. 2010).

In re Pacific Lumber Co., 584 F.3d 229 (5th Cir. 2009).