The Third Circuit Affirms Decision Denying Secured Creditors the Right to Credit Bid

Introduction

On March 22, 2010, the Third Circuit Court of Appeals in the *Philadelphia Newspapers* bankruptcy proceedings issued a split decision that may significantly impair a secured creditor's ability to credit bid in a sale of its collateral pursuant to a plan. The Third Circuit joined the Fifth Circuit, which ruled in September 2009, in the *Pacific Lumber* case, that the Bankruptcy Code does not provide secured lenders the absolute right to credit bid at an auction sale pursuant to a reorganization plan.

Background

The Debtors operated a number of print and online publications in the Philadelphia market. The Debtors financed their operations and certain acquisitions by obtaining a term loan and revolving credit facility from a group of lenders (collectively, the "Senior Lenders"). As security, the Debtors granted the Senior Lenders first-priority liens and continuing pledges, and security interests in substantially all of the Debtors' assets. The Debtors' indebtedness exceeded $300 million at the time of the bankruptcy filing. Neither the amount of the indebtedness nor the validity of the Senior Lenders' liens were challenged.

Unable to restructure their indebtedness under the loan documents through negotiations with the Senior Lenders, the Debtors filed for protection under Chapter 11 of the Bankruptcy Code. In the bankruptcy proceeding, the Debtors identified a private buyer to purchase substantially all of their assets at a public auction pursuant to a plan of reorganization. The Debtors proposed that any potential buyer for the assets submit an "all cash" bid at the public auction. Thus, the Senior Lenders were prevented from credit bidding.

Relevant Provisions of the Bankruptcy Code

Section 363(k) of the Bankruptcy Code provides a secured lender the right to credit bid when its collateral is sold outside the ordinary course of business. It would appear that a sale of substantially all of a debtor's assets, whether pursuant to a plan of reorganization or otherwise, would be outside the ordinary course of business. Notwithstanding the foregoing, the Debtors asserted that section 1129(b) of the Bankruptcy Code allowed them to bypass section 363(k) and obtain approval of a sale in which the Senior Lenders were barred from credit bidding, relying on section 1129(b)(2)(A)(iii).

Section 1129(b) provides, in pertinent part:

(b)

(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides —

(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 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 this title, 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)(emphasis added).

Opinion of the District Court

On appeal from the Bankruptcy Court, the case presented the issue of whether the Bankruptcy Court erred in finding that the Senior Lenders had a right to credit bid at an auction sale pursuant to a plan of reorganization. The District Court held that "under the circumstances of this case, the Bankruptcy Court erred in rejecting the proposed bid procedures on the ground that the [Senior Lenders] had a right to credit bid under 11 U.S.C. § 1129(b)(2)(A)(iii)." The District Court found only section 1129(b) to be relevant in its analysis. Section 1129(b) requires that a plan of reorganization be "*fair and equitable*," and provides three alternative ways by which this standard could be satisfied when a secured lender is subject to a cramdown. The District Court focused on two of those alternatives — subsections 1129(b)(2)(A)(ii) (the "*Sale Prong*") and 1129(b)(2)(A)(iii) (the "*Indubitable Equivalent Prong*").

The Sale Prong expressly provides a secured creditor the right to credit bid in a sale of its collateral, while the Indubitable Equivalent Prong is silent on this point. The Debtors argued that they only needed to satisfy the Indubitable Equivalent Prong to cram down the Senior Lenders. This prong requires that secured creditors receive the "indubitable equivalent" of their claim. "Indubitable Equivalent" is a judicially-created concept that was incorporated into the Bankruptcy Code in 1978. When the District Court issued its opinion, this term had never been defined. Ordinarily, this concept has been used where a debtor needs to free a particular piece of collateral from any existing liens. If the debtor has another asset that is virtually identical to the secured lender's collateral, and the secured lender is given identical rights with respect to the asset (the substitute collateral), courts have held that the lender is appropriately protected because it has been given the indubitable equivalent of its prior position. The best example is where one parcel of real estate with an equivalent value and an equally desirable location is substituted for another.

The Bankruptcy Court had ruled that section 1129(b)(2)(A) was at a minimum ambiguous, and found that legislative history and other Code sections made clear that Secured Lenders must be allowed to credit bid in any sale of their collateral. On appeal, the District Court concluded otherwise, stating that section 1129(b)(2)(A) "provides three distinct alternative arrangements for satisfaction of plan confirmation in the context of cramdown of ... secured creditors and that the Debtors may select any of these to proceed to confirmation." Analyzing the Debtors' chosen alternative, the District Court added that the Indubitable Equivalent Prong provides "absolutely no reference to the right to credit bid created by section 363(k)" and concluded that this prong was "flexible." The District Court further stated that "Congress could well have intended to provide a debtor with latitude in proposing a sale under this approach which precluded the right to credit bid but still generated the indubitable equivalent of the secured creditor's claim."

The District Court decision comported with a recent decision from the Fifth Circuit — *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009). Both courts found that the Sale Prong was not the exclusive cramdown means available to confirm a plan when a secured lender's collateral is sold pursuant to a plan of reorganization. The Fifth Circuit's decision ventured further by affirming that the *Pacific Lumber* plan was "fair and equitable" under the Indubitable Equivalent Prong and therefore confirmable, despite the fact that the secured creditors were not permitted to credit bid. In *Pacific Lumber*, the Fifth Circuit held that a plan that proposed to satisfy the secured lender in cash could be confirmed as "fair and equitable" as long as the distribution to the lender accurately reflected the value of the collateral. The value of the collateral in *Pacific Lumber* had been judicially determined after an extensive evidentiary hearing.

Opinion of the Third Circuit

The issue on appeal was whether section 1129(b)(2)(A) of the Bankruptcy Code requires that any debtor who proposes, as part of its plan of reorganization, a sale of assets free of liens must allow creditors whose loans are secured by those assets to bid their credit at the auction. The Third Circuit held that "[b]ecause §1129(b) unambiguously permits a court to confirm a reorganization plan so long as secured lenders are provided the 'indubitable equivalent' of their secured interest," the bid procedures may strip the secured lenders of the right to credit bid and satisfy the requirements of section 1129(b) as a matter of law.

The Third Circuit Court of Appeals affirmed the decision of the U.S. District Court. The Court of Appeals concluded that the Bankruptcy Code permitted the debtors to preclude a credit bid in a sale under a plan of reorganization. The Court so held because subsection (ii) of section 1129(b)(2)(A) is not the exclusive way to conduct a "fair and equitable" plan sale of assets. Instead, a sale under subsection (iii), which does not allow credit bidding, is also allowed.

The Court ruled that 1129(b)(2)(A) was clear, and allowed a "debtor to conduct an asset sale [pursuant to a plan] under subsection (iii) without allowing secured lenders to credit bid." The Court held that Congress intentionally included a method of conducting an asset sale without a credit bid as long as that method satisfactorily protected the secured creditor's interest. A plan may provide the "indubitable equivalent" to the secured lenders without requiring the opportunity for those lenders to credit bid. The Court defined "indubitable equivalent" — something no court had previously done — as "the unquestionable value of a lender's secured interest in the collateral." Notably, both the Third Circuit and the District Court left open the question of whether the indubitable equivalent standard could be satisfied in a sale pursuant to a plan without providing the lenders with the right to credit bid.

Therefore, a debtor may cram down secured creditors in an asset sale under a plan of reorganization, by precluding credit bids and granting secured creditors the "indubitable equivalent" of their claims under subsection (iii). But the plan must still be "fair and equitable." Whether the plan is "fair and equitable" to secured lenders is a question for plan confirmation and cannot be answered at the time of the sale. While the debtors may preclude credit bidding at an auction of their assets, the secured lenders may argue at the time of confirmation that the plan does not provide the "indubitable equivalent" of their claims and so is not "fair and equitable," and should not be confirmed.

The Dissent

Third Circuit Judge Ambro dissented from the majority opinion. He argued that section 1129(b)(2)(A) is ambiguous, and that it was therefore appropriate to analyze the rules of statutory interpretation, the context and legislative history of the Bankruptcy Code, and comments of the drafters of the Code to determine whether section 1129(b)(2)(A)(ii) was the exclusive section to sell assets pursuant to a plan. Judge Ambro concluded that it was the exclusive section because the specific provision of section 1129(b)(2)(A)(ii) exclusively governed asset sales in the context of plans, as opposed to the general "indubitable equivalent" standard in subsection (iii). In other words, the indubitable equivalent standard did not apply in the context of a sale pursuant to a plan. As subsection (ii) expressly permits credit bidding, Judge Ambro would have reversed the District Court's decision in favor of that of the Bankruptcy Court. This interpretation, he noted, is consistent with the secured lenders' expectation that they would be able to credit bid and is consistent with the settled expectations of lenders and debtors and thus part of the prepetition bargain to which the lenders are entitled.

Conclusion

The majority opinion creates a new burden for secured lenders, and contradicts their reasonable expectations based on existing law. It would allow debtors to propose auctions in the context of a plan that would preclude credit bidding. The opinion, however, leaves open the question of whether the indubitable equivalent standard can be satisfied without permitting a lender to credit bid. Thus, while a creditor may not be able to credit bid, it may still, at a later time, object to the plan of reorganization on the grounds that the plan is not "fair and equitable."

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