

Bankruptcy & Reorganization | April 5, 2010

## Recent Case Furthers Trend Towards Limiting Secured Creditors' Right to Credit Bid in Connection with Sales Under a Debtor's Plan of Reorganization

The ability of secured creditors to credit bid if the collateral securing their debt were sold in a bankruptcy proceeding is often viewed as a fundamental creditor protection. A recent decision from the Court of Appeals for the Third Circuit, however, found that a secured creditor may not have a right in the context of a plan of reorganization that involves a sale of collateral. In the Third Circuit's decision in *In re Philadelphia Newspapers, LLC*,<sup>1</sup> the court held that section 1129(b)(2)(A) of the Bankruptcy Code is unambiguous and that a plain reading of such provision permits a debtor to sell the collateral securing a secured lender's loan without allowing the secured lender the opportunity to credit bid its claim so long as the debtor's plan provides the secured lender with the "indubitable equivalent" value of its collateral.

At the center of this decision is section 1129(b)(2)(A) of the Bankruptcy Code, which contains the test for determining whether a plan of reorganization can be crammed down on a class of secured creditors that rejected the plan. In order for a cramdown plan to be confirmed, the proponent of the plan must demonstrate to the bankruptcy court that the plan is "fair and equitable" with respect to each class that rejected the plan. Section 1129(b)(2)(A) provides that a plan would be "fair and equitable" to a secured creditor if it provided for: (i) the secured creditor to retain its liens and receive cash payments equal to the allowed amount of the claim; (ii) "the sale, subject to section 363(k)" of the collateral, with the liens of the secured creditor attaching to the proceeds (the "Sale Prong") or (iii) the secured creditor to receive the "indubitable equivalent" of its claim (the "Indubitable Equivalent Prong"). Section 363(k), on which the Sale Prong is predicated, contains the right to

credit bid, stating that "unless the court for cause orders otherwise the holder of [a secured] claim may bid at such sale, and, if the holder of such claim purchases the property, [it] may offset such claim against the purchase price of such property."<sup>2</sup>

<sup>1</sup> *In re Philadelphia Newspapers, LLC*, Nos. 09-4266, 09-4349, 2010 WL 1006647 (3d Cir. Mar. 22, 2010).

<sup>2</sup> 11 U.S.C. § 363(k). As the language in 363(k) makes clear, the right to credit bid is not absolute, and can be denied for cause shown. Although rarely utilized, courts have denied credit bidding in a 363 sale context when the claim or lien was subject to a bona fide dispute and there was a need for a prompt sale of the assets. See *In re Akard St. Funds*, No. Civ. A. 3:10-CV-1927-D, 2001 WL 1568332 (N.D. Tex. Dec. 4, 2001); see also *In re McMullan*, 196 B.R. 818 (Bankr. W.D. Ark. 1996) (holding that a creditor would not be entitled to credit bid any of its alleged liens or security interests because the validity of its liens and security interests was unresolved).

## Background

Philadelphia Newspapers, LLC and certain of its affiliates (the “Debtors”) own and operate several print newspapers that were acquired by the Debtors in July 2006 for \$515 million as part of an acquisition by a group of investors. Funding for the acquisition came in part from a \$295 million loan from a group of lenders (the “Lenders”) that was secured by a first priority lien in substantially all of the Debtors’ real and personal property. At the time of the bankruptcy filing, the present value of the loan was approximately \$318 million. On August 20, 2009, the Debtors filed a joint plan of reorganization (the “Plan”) that provided for substantially all of the Debtors’ assets to be sold at a public auction, free and clear of all liens pursuant to sections 1123(a) and (b) of the Bankruptcy Code. Under the terms of the Plan, the Lenders would be limited to the proceeds from the auction – for which a stalking horse (that is majority owned by an existing equity holder) bid had been accepted that would result in \$37 million in cash proceeds – plus a distribution of real property valued at approximately \$29.5 million (for a total projected recovery of \$56.5 million). The Plan also provided that as a result of the sale of the Lender’s collateral, the Lenders would not be allowed to elect, under section 1111(b) of the Bankruptcy Code, to have their full claim treated as a secured claim.<sup>3</sup>

In conjunction with the filing of the plan of reorganization, the Debtors filed a motion for approval of protections for the stalking horse bidder, and bid procedures that required all bidders to fund the purchase with cash. The requirement of cash bids only would result in the secured creditors having no ability to credit bid their \$318 million in debt, despite the prospects that

they would receive only a \$56.5 million recovery (assuming no overbid at the auction).

On October 8, 2009, the bankruptcy court issued an order refusing to bar the lenders from credit bidding. The bankruptcy court held that although the Plan proceeded under the Indubitable Equivalent Prong of section 1129(b)(2)(A), the sale was really structured under the Sale Prong and in light of other provisions of the Bankruptcy Code, the Lenders must be permitted to credit bid their debt at the sale of the collateral. The Debtors appealed the bankruptcy court’s decision to the District Court for the Eastern District of Pennsylvania (the “District Court”).

On appeal, the District Court relied upon a recent decision issued by the Fifth Circuit in *In re Pacific Lumber*, in which the Fifth Circuit held that in the context of a private judicial sale of assets under a plan, the Indubitable Equivalent Prong can afford a distinct basis for confirming a plan so long as the plan in fact offers the realization of the indubitable equivalent of such claims. The District Court found that the bankruptcy court incorrectly determined the language of section 1129(b)(2)(A) to be ambiguous, and instead found the language to be clear in providing three distinct alternative arrangements for plan confirmation and that a debtor is free to select any of the three to proceed to confirmation.<sup>4</sup> The District Court held that this clear contrasting language proved that Congress intended three separate paths to confirmation and the bankruptcy court erred in its conclusion that the Lenders had a statutory right to credit bid under the Indubitable Equivalent Prong.<sup>5</sup> In reaching its decision, the District Court observed that the very “vagueness of the term ‘indubitable equivalent’ is an invitation to craft an appropriate treatment of a secured creditor’s claim, separate and apart from subsection (ii).”<sup>6</sup> Relying on *Pacific Lumber*, the District Court found that a plan sale is potentially

<sup>3</sup> Under section 1111(b) of the Bankruptcy Code, a creditor has the right to elect to have the full value of its claim treated as secured regardless of the value of the collateral. Such an election, however, cannot be made if “the holder of a claim . . . has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.” 11 U.S.C. § 1111(b)(1)(B).

<sup>4</sup> *In re Philadelphia Newspapers, LLC*, 2009 WL 3756362 (E.D. Pa. Nov. 10, 2009).

<sup>5</sup> *Id.* at \*37.

<sup>6</sup> *Id.* at \*39.

another means to satisfy the indubitable equivalent standard and that it is entirely plausible that Congress envisioned a situation where a debtor could assure a secured creditor the benefit of its bargain in an asset sale even without permitting a credit bid.

## The Third Circuit's Opinion

On March 22, 2010, the Third Circuit issued a decision affirming the District Court's decision.<sup>7</sup> The Third Circuit concluded that the plain and unambiguous language of section 1129(b)(2)(A) permits a debtor to conduct an asset sale under the Indubitable Equivalent Prong without permitting a secured lenders the right to credit bid. The Third Circuit disagreed with the Lenders' reliance on the canon of statutory interpretation that the specific term (the Sale Prong) prevails over the general term (the Indubitable Equivalent Prong) because that canon only applies when the general provision undermines a limitation created by the specific provision.<sup>8</sup>

In reaching its decision, the Third Circuit held that the Indubitable Equivalent Prong does not operate as a limitation because the disjunctive nature of section 1129 clearly shows that a plan can be confirmed so long as it meets any one of the three subsections of section 1129 and that the process chosen by the plan proponent does not dictate which requirements must be met for confirmation.<sup>9</sup> Although the Third Circuit observed that the term "indubitable equivalent" is broad, it concluded that the term was not unclear or ambiguous in this context as it reflected an intent that the "unquestionable value of a lender's secured interest [is] in the collateral."<sup>10</sup>

The Third Circuit also rejected the Lenders' argument that a secured lender must either be permitted to treat its entire claim as a secured claim under section 1111(b) of

the Bankruptcy Code, or have the right to bid its claim in the context of a sale.<sup>11</sup> The Third Circuit observed that there is no such linkage between the right to credit bid and the 1111(b) election under a plain reading of the Bankruptcy Code, because circumstances exist where a secured creditor has neither the right to make an 1111(b) election nor to credit bid under 363(k).<sup>12</sup>

The Third Circuit emphasized, as did the District Court, that such reading of section 1129 does not guarantee confirmation – the court has not yet been asked to determine whether the indubitable equivalent has been provided to the Lenders as a result of the sale. The Lenders would remain free to object at confirmation that they did not receive the indubitable equivalent of their collateral in the absence of a credit bid.

## The Dissent

In a lengthy dissent, Circuit Judge Ambro, a former practicing bankruptcy attorney, argued that Congress intended for the Sale Prong to be the exclusive method through which a debtor can cram down a plan when selling collateral free of liens.<sup>13</sup> In his dissent, Judge Ambro made clear that few courts in the last thirty years of Bankruptcy Code jurisprudence have interpreted section 1129(b)(2)(A) of the Bankruptcy Code the way the majority has in its decision.<sup>14</sup> Furthermore, Judge Ambro highlighted the practical problems associated with the majority's decision in that secured creditors rely on their ability to credit bid and such a decision may ultimately increase the cost of credit.<sup>15</sup> In arguing that there are other plausible interpretations of section 1129(b)(2)(A), Judge Ambro stated that Congress did not intend for the

<sup>7</sup> *Philadelphia Newspapers, LLC*, 2010 WL 1006647, at \*3.

<sup>8</sup> *Id.* at \*6.

<sup>9</sup> *Id.* at \*9.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at \*14.

<sup>12</sup> In effect, the court rejected the notion that the right to either credit bid or make an 1111(b) election was designed to preserve the same rights as exist under non-bankruptcy law. *Id.* at n.15. As described below, this was a major area of disagreement as expressed in the dissent.

<sup>13</sup> *Id.* at \*17.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at \*32.

three alternatives of section 1129 to be applied universally to any plan. Rather, each alternative is a distinct route with specific requirements that must be applied depending on how the plan proposes to treat the claims of secured creditors.<sup>16</sup> Although the term “indubitable equivalent” is broad, as pointed out by the majority, it was not designed to supplant the Sale Prong.

Lastly, the dissent argued that when read together, sections 1129(b)(2)(A), 363(k), 1111(b) and 1123(a)(5)(D)<sup>17</sup> “are part of a comprehensive arrangement enacted by Congress to avoid the pitfalls of undervaluation, regardless of the mechanism chosen, and thereby ensures that the rights of secured creditors are protected while maximizing the value of the collateral to the estate and minimizing deficiency claims . . . .”<sup>18</sup> Providing secured creditors the right to credit bid in the context of a plan that contemplates the sale of collateral free and clear of all liens furthers this comprehensive arrangement.

## Impact of Decision

As noted by the Fifth Circuit in the *Pacific Lumber* case, most contested reorganization plans that are crammed down on secured creditors follow either the path of having secured creditors retain their liens and receive deferred payments or the path of the Sale Prong. As such, there is relatively little case law available to guide secured creditors in determining what measures constitute the indubitable equivalent for the value of their allowed claim to satisfy the Indubitable Equivalent Prong. After the

ruling in *Philadelphia Newspapers*, parties have some guidance that paying cash to a secured creditor – assuming the amount accurately reflects the value of the collateral – could be considered indubitable equivalent treatment. Even if courts in other jurisdictions were willing to adopt the statutory construction utilized in *Pacific Lumber* and *Philadelphia Newspapers*, it is possible that the lack of an ability to credit bid could provide a justification for the court to hold that a proper price was not obtained for the assets, and, therefore, by definition the plan did not provide the indubitable equivalent.

One potential context in which a secured creditor could seek to limit the debtor’s ability to invoke the Indubitable Equivalent Prong in the context of a sale would be in a situation where it is consensually agreeing to the use of cash collateral under section 363 of the Bankruptcy Code. In such a situation, the secured creditor could seek as part of its adequate protection package to condition the use of its cash collateral on the debtor’s agreement that if it were to later pursue a sale of collateral under a plan, it would only seek to cram down the secured creditor under the Sale Prong.<sup>19</sup>

---

<sup>18</sup> *Philadelphia Newspapers LLC*, 2010 WL 1006647, at \*29.

<sup>19</sup> Such a strategy was utilized in *In re Capmark Financial Group* where the agent for a secured debt facility, as part of its adequate protection package, negotiated into the cash collateral order a requirement that “[i]n the event the Prepetition Collateral is sold pursuant to a chapter 11 plan, the Debtors shall not seek confirmation of such plan under section 1129 (b)(2)(A) of the Bankruptcy Code for the class of claims that includes the Prepetition Secured Credit Obligations, other than pursuant to the [Sale Prong] of the Bankruptcy Code.” Final Order (I) Authorizing Use of Certain Cash Collateral Postpetition and (II) Providing Adequate Protection to Prepetition Secured Parties in Connection Therewith at ¶ 15, *In re Capmark Financial Group Inc.*, 2009 WL 5190582 (Bankr. D. Del. Dec. 22, 2009).

<sup>16</sup> *Id.* at \*22.

<sup>17</sup> Section 1123(a)(5)(D) provides the statutory basis for a sale of collateral under a plan of reorganization.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

**Fredric Sosnick**  
New York  
+1.212.848.8571  
fsosnick@shearman.com

**Douglas P. Bartner**  
New York  
+1.212.848.8190  
dbartner@shearman.com

**James L. Garrity, Jr.**  
New York  
+1.212.848.4879  
jgarrity@shearman.com

**Andrew V. Tenzer**  
New York  
+1.212.848.7799  
atenzer@shearman.com

**Michael H. Torkin**  
New York  
+1.212.848.8283  
mtorkin@shearman.com

**Steven E. Sherman**  
San Francisco  
+1.415.616.1260  
sesherman@shearman.com

**Edmund M. Emrich**  
New York  
+1.212.848.7337  
edmund.emrich@shearman.com

**Susan A. Fennessey**  
New York  
+1.212.848.7878  
sfennessey@shearman.com

**Jill K. Frizzley**  
New York  
+1.212.848.8174  
jfrizzley@shearman.com

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069 | WWW.SHEARMAN.COM

©2010 Shearman & Sterling LLP. As used herein, "Shearman & Sterling" refers to Shearman & Sterling LLP, a limited liability partnership organized under the laws of the State of Delaware.