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March 2010

Third Circuit Finds No Absolute Right To Credit Bid By A Secured Lender

Is This A Game Changer? Will The Supreme Court Get An Opportunity To Provide The Conclusive Answer To This Issue?

BY THE FINANCE AND RESTRUCTURING PRACTICE

A secured lender's well-worn tools to protect its security interest have included the right to credit bid when its collateral is being sold. Credit bidding refers to the ability of a secured lender to participate in a foreclosure or other form of auction for assets that are subject to its liens and, where the cash bids yield less value than the secured lender believes its collateral to be worth, to bid all or a portion of its debt in lieu of cash. Because any cash the secured lender pays would be round-tripped back to itself as proceeds of collateral, the lender need not actually put cash on the table; instead, it reduces the underlying debt by as much as it has to bid to take title to the collateral.

The same process has been long recognized in bankruptcy cases as well, and many lenders assumed the right to credit bid was absolute. In an appeal arising from the chapter 11 case *In re Philadelphia Newspapers, LLC.*, however, a panel of the Third Circuit Court of Appeals ruled on March 22, 2010, that a debtor may, pursuant to a plan of reorganization, sell the secured creditor's collateral free and clear of liens, and need not provide the secured lender with a right to credit bid in the sale process, so long as the plan otherwise provides the secured lender with the indubitable equivalent of its secured claim. For many secured lenders, the loss of a guaranteed right to credit bid will come as an unpleasant surprise.

"Cram Down" Provisions of Bankruptcy Code Section 1129(b)

The decision in *Citizens Bank of Penn. v. Phila. Newspapers, LLC*, No. 09-4266 (3rd Cir. Mar. 22, 2010) arises under the "cram down" provisions of Bankruptcy Code section 1129(b).[1] That section permits a debtor (or other plan proponent) to confirm a chapter 11 plan of reorganization over the objection of a class of creditors (such as secured creditors), so long as the plan (i) does not discriminate unfairly among classes of claims or interests, and (ii) is fair and equitable with respect to those classes of claims or interests that have not accepted the plan. Section 1129(b)(2)(A) states that a plan is "fair and equitable" with respect to a class of secured claims if 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.
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> (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
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> (iii) for the realization by the holders of the indubitable equivalent of such claims.[2]

Clause (ii) quoted above references section 363(k), which assures the right of a secured lender to credit bid where its collateral is being sold outside of a plan, as follows:

> At a sale under subsection (b) of this section [*i.e.*, a sale outside of the ordinary course of business] of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.[3]

In short, section 1129(b)(2)(A) permits a plan to be crammed down on a non-consenting class of secured creditors as long as one of three tests is met: (1) the secured creditors keep their liens and receive deferred cash payments under clause (i); (2) assets are sold free and clear of liens where the secured creditors are permitted to credit bid under clause (ii); or (3) the secured creditors receive the "indubitable equivalent" of their claims under clause (iii). The Bankruptcy Code nowhere defines "indubitable equivalent", however, and examples in case law vary tremendously.

Philadelphia Newspapers Decision

As set forth above, clause (ii) of section 1129(b)(2)(A) unequivocally permits the sale of collateral free and clear of liens, subject to the secured creditors' right to credit bid. The question addressed by the three-judge panel in *Philadelphia Newspapers*, however, was whether clause (ii) provides the *exclusive* "fair and equitable" means to sell collateral free and clear of liens, such that the right to credit bid must always be respected. The majority, over a strong dissent by Judge Ambro, said "no".

Before discussing the holding and the dissent, some factual context is helpful. The *Philadelphia Newspapers* debtors had proposed a plan to sell, at a public auction, substantially all of their assets free and clear of liens. The debtors had selected as the stalking horse bidder a group with ties to insiders and equity, which proposed to buy the assets for approximately $41 million in value. The debtors sought bankruptcy court approval of bid procedures to solicit higher and better offers, but specifically provided that offers had to be in cash (i.e., no credit bids allowed). The secured lenders whose collateral was being sold held a claim for $318 million, and objected to the bid procedures because they were precluded from credit bidding. The bankruptcy court agreed with the secured lenders that the debtors could only sell their assets free and clear of liens by proceeding under clause (ii) of section 1129(b)(2)(A), which expressly requires a sale to be subject to the credit bid provisions section 363(k). The bankruptcy court therefore modified the bid procedures to allow for credit bids.

On appeal, however, the district court reversed, and held that the debtors could proceed with a sale either under clause (ii) (which would require credit bids to be accepted) or under clause (iii) (which

would not necessarily require acceptance of credit bids). The district court reasoned that section 1129(b)(2)(A) contains three distinct routes to plan confirmation, and that a plan sale could be crafted pursuant to clause (iii) which provides secured creditors with the indubitable equivalent of their claims without allowance for credit bidding. In concept, the district court was satisfied that the lenders would receive the entire cash proceeds of the sale transaction generated by a public auction, and that such treatment could be the "indubitable equivalent" of their secured claims.

The majority of the Third Circuit panel agreed with the district court. Judge Fisher began the majority opinion with the statutory language of section 1129(b)(2)(A) quoted above, where the three clauses are connected with the word "or". Therefore, a plan proponent could fashion a plan under any of the three clauses. The majority concluded that the plain meaning of section 1129(b)(2)(A)(iii) permits a plan where the secured creditor realizes upon its claims by any means that provide the creditor with the "indubitable equivalent" of that secured claim. *Slip Op.* at 15. It found no ambiguity in the text of section 1129(b)(2)(A) or the phrase "indubitable equivalent" and did not agree with the lenders or the dissent that reference to legislative history was appropriate. *Id.* at 34.[4] The majority therefore held, as a matter of law, that section 1129(b)(2)(A)(iii) permits, among other possibilities, a plan to sell assets free and clear of a secured creditor's liens and that a secured creditor does not have an absolute right to credit bid where a debtor proceeds under clause (iii). *Id*. at 43. In so holding, the majority sided with a recent Fifth Circuit decision that similarly held clause (iii) permits assets sales without credit bidding.[5] Notably, the majority specifically refused to consider whether the plan treatment proposed in *Philadelphia Newspapers* was in fact the "indubitable equivalent" of the secured lenders' claims, observing that was a plan confirmation issue and not a bid procedures issue. *Id* at 43-44.

Judge Ambro, a well respected former Delaware bankruptcy practitioner and the sole dissenting judge on the panel, took issue with the majority's approach.[6] Judge Ambro asserted that section 1129(b)(2)(A) has more than one plausible interpretation, and therefore that the section is ambiguous. *In re Phila. Newspapers, LLC,* No. 09-4266 at 9 (Ambro, J., dissenting) (3rd Cir. Mar. 22, 2010). Specifically, Judge Ambro believed that section 1129(b)(2)(A) could be read to say that <u>any</u> plan in which liens are retained must satisfy clause (i), that <u>any</u> plan sale of assets free and clear of liens must be conducted pursuant to clause (ii) (and thus be subject to credit bids), and that the clause (iii) "indubitable equivalent" prong is reserved for situations <u>other than</u> lien retention or asset sales free and clear of liens. *Id.* at 20. Finding an ambiguity between this interpretation and that espoused by the majority, Judge Ambro would then look to principles of statutory construction, and most importantly, the rule that specific clauses prevail over general clauses. *Id.* at 21, 24. Since clause (ii) specifically addresses sales free and clear of liens, Judge Ambro argued, then the general "catchall" language of clause (iii) cannot also be read to address sales free and clear of liens. *Id.* at 26. Moreover, Judge Ambro charged that the majority's interpretation renders clause (ii) superfluous; that is, if clause (ii) requires a sale free and clear to permit credit bidding, and clause (iii) neither forbids nor requires credit bidding, then clause (ii) is entirely superfluous. *Id.* at 29. The same would be true of clause (i); that is, under the majority's analysis, clause (iii) could arguably be used to circumvent the strict requirements of clause (i) when a secured creditor is maintaining its liens. Finally, in Judge Ambro's view, other provisions of the Bankruptcy Code demonstrate a Congressional intent to adopt settled non-bankruptcy law allowing a secured lender to credit bid in any foreclosure. *Id.* at 31. Judge Ambro concluded that interpreting clause (iii) to cover sales free and clear of liens is inconsistent with principles of statutory construction, with Congressional intent, and with the settled expectations of lenders and borrowers. *Id.* at 48.

Observations

The repercussions of the majority opinion in *Philadelphia Newspapers* may not be fully understood for some time because, procedurally, a number of avenues remain open to the parties to that appeal. The secured lenders are likely to seek *en banc* rehearing or, ultimately, Supreme Court review, or the matter may return to the bankruptcy court for factual findings on whether the specific approach pursued by the debtors meets the "indubitable equivalent" standard. Under the later scenario, the lenders' appeal could be mooted if the plan providing for the sale fails to satisfy clause (iii), which would leave the precedent of *Philadelphia Newspapers* intact. The debtors' DIP financing is apparently maturing on March 31, 2010, and, absent relief from the bankruptcy court, the exercise of remedies by the DIP lenders could also moot a further appeal of the Third Circuit decision.[7]

On the merits of the *Philadelphia Newspapers* decision, Judge Ambro may well be correct that legislative intent was to require that all asset sales free and clear of liens must be conducted pursuant to clause (ii) of section 1129(b)(2)(A), particularly when the dispute is viewed against the backdrop of settled business expectations into what it means to hold a security interest. Nevertheless, the majority's view that section 1129(b)(2)(A) is unambiguous on its face and therefore that no recourse to legislative intent is warranted may preclude the issue of Congressional intent from being fully addressed.

Assuming no successful challenge to the majority opinion, then, it is currently the law of the Third Circuit (and indeed of the Fifth Circuit) that a secured creditor does not have the absolute right to credit bid when a plan seeks to sell the secured creditor's collateral free and clear of its liens. Moreover, since no other Circuit Court has ruled on this issue, a secured lender would be prudent to assume that the rule of *Philadelphia Newspapers* and *Pacific Lumber* could apply in any bankruptcy case. The heightened degree of uncertainty as to whether a secured creditor will be able to realize upon its collateral during a bankruptcy case may well translate to higher interest rates to compensate the lender for that uncertainty, and perhaps to greater efforts to realize upon collateral outside of a chapter 11 case.

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[1] Unless otherwise indicated, all section references are to the United States Bankruptcy Code, 11 U.S.C. § 101, *et seq.*

[2] 11 U.S.C. § 1129(b)(2)(A)(i)-(iii).

[3] 11 U.S.C. § 363(k).

[4] Judge Smith concurred in the majority opinion except for a section in which Judge Fisher addressed why, even if legislative history were consulted, the outcome would be the same. Judge Smith opined that the inquiry should stop with the plain meaning and that recourse to the legislative history was unnecessary. *In re Phila. Newspapers, LLC*, No. 09-4266 at 1 (Smith, J., concurring) (3rd Cir. Mar. 22, 2010).

[5] *See Bank of N.Y. Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009) (cited in *Slip Op.* at 31-32). *Pacific Lumber* was in a procedurally different posture that *Philadelphia Newspapers* but similarly concluded that secured lenders do not have the power to insist upon credit bidding when their collateral is to be sold pursuant to a plan. In that case, a plan had been confirmed after a three month confirmation trial (and after extensive valuation evidence was taken) that effectively sold collateral without permitting the secured lenders to submit a credit bid and then used the cash proceeds to pay off the secured lenders' claims in an amount allowed by the bankruptcy court. The Fifth Circuit held that the three clauses of section 1129(b)(2)(A) were disjunctive, that the plan proponents could, under clause (iii), sell assets free and clear without affording a right to credit bid, and that the valuation evidence established that the secured lenders were receiving the indubitable equivalent of the allowed amount of their secured claims. *See Pacific Lumber*, 584 F.3d at 245-46, 248-49. Notably, the Fifth Circuit criticized the secured lenders for "making little effort to prove a clear error" in the bankruptcy court's valuation. *See id.* at 248.

[6] Although the appeal had been brought to resolve the question of section 1129(b)(2)(A) as a matter of law, Judge Ambro took pains to address the facts regarding the debtors' selection of a stalking horse with insider ties and an intent to buy the assets "on the cheap". *See In re Phila. Newspapers, LLC*, No. 09-4266 at 2-4 (Ambro, J., dissenting) (3rd Cir. Mar. 22, 2010). Whether the particular facts in *Philadelphia Newspapers* give the bankruptcy court a reason to deny the sale to the stalking horse bidder remains to be seen.

[7] By motion dated March 23, 2010, the *Philadelphia Newspapers* debtors are seeking to force an extension of the March 31 maturity data of their DIP loan.