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Chapter 11 **Credit Bidding** Called Into Question

'Philadelphia Newspapers' ruling may signal a changing tide.

THE RECENT DECISION of the U.S. District Court for the Eastern District of Pennsylvania in the *Philadelphia Newspapers* matter[1] has turned the question of whether or not secured creditors are entitled to credit bid their secured debt, in a sale taking place under a plan of reorganization, into a contentious issue.

BY SHMUEL VASSER AND NICOLE DUVA

Prior to this decision and that of the Fifth Circuit in *Pacific Lumber*,[2] it was generally understood that secured lenders can always protect the inherent value of their collateral, whether via a credit bid at a sale of their collateral under either §363 of the Bankruptcy Code or pursuant to a plan of reorganization or, in the case of a non-recourse secured lender, through making an election under §1111(b) of the Bankruptcy Code.

In *Philadelphia Newspapers*, the district court reversed the bankruptcy court and held that when the sale of the collateral is conducted pursuant to a Chapter 11 plan, the secured lender may not be entitled to credit bid its secured debt.

In the current economic environment, where credit is tight and many bankruptcy cases are filed in order to consummate sales to the debtors' secured creditors, either via a stand alone sale or a sale under a plan, the significance of this holding cannot be overstated. It goes to the heart of the secured creditor's ability to influence the disposition of its collateral as well as its realization of the collateral's value.

Credit Bid Principles

When debtors in bankruptcy propose to sell encumbered assets in sales not occurring in conjunction with confirmation of a Chapter 11 plan, §363(k) of the Bankruptcy Code allows the secured creditor, unless the court orders otherwise, to credit bid its secured claim.[3] Stated differently, while all other bidders for the assets to be sold must provide cash or debt as the purchase price, the secured creditor can simply offer to reduce or eliminate its secured claim as the purchase price currency.

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The rights of a secured creditor in the context of Chapter 11 plan confirmation are governed by §1129 of the Bankruptcy Code. When faced with a so-called "cram down" plan,[4] wherein at least one class of claimants has voted to accept the plan and at least one class has voted to reject it, secured creditors' rights are governed by §1129(b)(2)(A). This section provides that for the plan to be confirmable it must be "fair and equitable."

With respect to secured claims, a plan is fair and equitable if it meets any of the following conditions:

(i) the secured creditors retain their liens and receive deferred cash payments totaling at least the value of their interest in the collateral,

(ii) the plan provides for the sale of the collateral, subject to the secured creditor's right to credit bid, or

(iii) the plan provides for the realization by the secured creditors of the indubitable equivalent of their claims.[5]

Previously, courts considering the issue have, among other things, refused to confirm a plan that did not afford secured lenders a right to credit bid, upheld confirmation of plans that did afford secured creditors that right, and found that a non-recourse secured lender was entitled to credit bid under §1129(b)(2)(A)(ii).[6]

Though these cases each preserved a right for the respective secured lenders to credit bid, none expressly states that such right is guaranteed by §1129(b)(2)(A).[7] In one decision, *In re Criimi Mae Inc.*, the bankruptcy court found that affording secured lenders the right to credit bid was not required and the debtors could meet the requirements of §1129(b)(2)(A) by providing the secured creditors with the indubitable equivalent of their claims under the plan.[8]

'Philadelphia Newspapers'

In *Philadelphia Newspapers*, the debtors are a group of media companies, which includes the Philadelphia Inquirer, the Philadelphia Daily News and philly.com.

The debtors proposed a plan of reorganization that includes a public auction for the sale of substantially all of the debtors' businesses and assets. In conjunction with the proposed sale, the debtors entered into an asset purchase agreement with the so-called stalking horse bidder, Philly Papers, LLC, for $37 million. Philly Papers, LLC shares several common owners with the parent company of the debtor entities.

The *Philadelphia Newspapers* decision results from the debtors' motion to approve bidding procedures for the auction of their assets. The bidding procedures provide that secured lenders are not permitted to credit bid; all bids must be in cash. Under the plan, the secured lenders would receive approximately $36 million in cash and real estate that the debtors estimate is worth $30 million ($66 million in total) in full satisfaction of their secured claim. The secured lenders are owed in excess of $300 million.

The bankruptcy court held that even when a sale is taking place under the auspices of a plan, the secured creditor must be afforded a right to credit bid.[9] As such, the debtors' proposed bidding procedures were rejected. A few short weeks later, the district court reversed on appeal and held that a Chapter 11 plan may be confirmable even if the sale proposed pursuant to the terms of the plan does not afford the secured creditor a right to credit bid.

In analyzing the text of §1129(b)(2)(A), the district court determined that the plain meaning of the statute provides three alternatives, each of which satisfies the fair and equitable standard with respect to secured creditors. As such, the debtors may propose a plan with an auction component that does not provide secured creditors with the right to credit bid by satisfying the two other alternatives provided by the statute, i.e., retention of their liens (the first alternative), or by the third alternative—providing the secured lenders with the indubitable equivalent of their claims.

The district court declined to inquire into whether the plan met the indubitable equivalent standard, considering the issue a confirmation one.

The district court relied, in part, on the Fifth Circuit's decision in *Pacific Lumber*, in which the bankruptcy court confirmed a plan that did not permit the secured lenders to credit bid. There are, however, meaningful factual differences between *Pacific Lumber* and *Philadelphia Newspapers*.

In *Pacific Lumber* the bankruptcy court engaged in an extensive valuation process pursuant to which

the court determined the value of the collateral, and therefore, the value that has to be provided to the secured lenders in order to provide them with the indubitable equivalent of their claims. The plan in turn, provided that the secured lenders be paid that amount in cash.

Critically, the secured lenders never objected to the proceedings in the bankruptcy court, prior to their confirmation objection. In the Court of Appeals' words: "The Noteholders have not established a predicate for their auction complaint—either by preserving a timely filed objection to the court's procedures or by showing of prejudice."[10]

The *Philadelphia Newspapers* bankruptcy court decision distinguished *Pacific Lumber* on this basis.[11] The district court, however, found such reasoning unavailing because it was not pertinent to the statutory interpretation of §1129(b)(2)(A) of the Bankruptcy Code.[12]

The district court also rejected the bankruptcy court's statutory interpretation of §1129(b)(2)(A). The bankruptcy court found the statute to be latently ambiguous because subsection (ii) of §1129(b)(2)(A) could be interpreted to mean either that a lender is entitled to credit bid only in a §363(b) sale by virtue of the inclusion of §363(k), which refers to a sale under §363(b), or that subsection (ii) imports the "essence" of §363(k) to this section of the Code and guarantees the right of a secured lender to credit bid.

The court then referred to the previous case law on the issue and the legislative history of §1111(b) of the Bankruptcy Code:

> Sale of property under §363 or under a plan is excluded from treatment under §1111(b) because of the secured party's right to credit bid in the full amount of its allowed claim at any sale of collateral under §363(k) of the House Amendment."[13]

After its review, the bankruptcy court concluded that §1129(b)(2)(A) should be interpreted as requiring compliance with §363(k) whenever a debtor seeks to conduct a sale pursuant to a plan of reorganization.

The district court found no ambiguity in the statute and disapproved of the bankruptcy court's examination of the congressional record. The district court noted that the legislative history of §1129(b)(2)(A) does not suggest that it should be informed by §1111(b) and that the legislative history of a statute cannot be used to contradict its plain meaning.

Arguably, some of the bankruptcy court's decision was influenced by the fact that the debtors were not exercising appropriate business judgment in their conduct of the auction. The court noted the "insider relationship" between the debtors and the stalking horse bidder. Among other things, the chairman of the stalking horse bidder is also the chairman of the holding company of the various debtors and, until recently, held 20 percent of the equity in the holding company.

The bankruptcy court went on to state that "[g]iving the Debtors the benefit of the doubt as to their motives, the Court nevertheless can discern no plausible business justification for the restriction which the Debtors seek to include in the Bid Procedures."[14] Because the bankruptcy court did not hear evidence concerning the debtors' business judgment, the district court considered such "holdings" of the bankruptcy court to be dicta and not to be addressed on appeal.

Form Over Substance?

On its face, the district court appeared to have applied §1129 of the Bankruptcy Code as written and enforced its literal terms. By doing so at the bidding order stage, however, the court might have prevented the secured lenders from in fact obtaining the indubitable equivalent of their secured claims.

In order to provide the secured creditors with the indubitable equivalent of their claims, the debtors must establish the value of the collateral being sold. In *Pacific Lumber*, the court determined the value of the collateral by conducting an extensive evidentiary hearing. Where, as in *Philadelphia Newspapers*, the value of the collateral is equal to the price set by the market, i.e., the highest and best bid at the auction, the auction must be structured in a way that fully integrates all market forces.

By prohibiting credit bidding, the debtors are de facto preventing the participation of the very entities that have the greatest interest in the outcome and are most likely to value the collateral highly. In essence, the debtors are excluding the most motivated buyers.

As such, the price determined by the auction is not necessarily the market price and, thus, not a reliable valuation of the assets. By definition, the plan cannot provide the secured lenders with the indubitable equivalent of their claims when the value of those claims has not been established.

The 'Philadelphia Newspapers' opinion, while **not binding** outside of the Eastern District of Pennsylvania, builds on the Fifth Circuit's decision in 'Pacific Lumber' and, together, those decisions **may signal** a **changing tide** with respect to the **level of control** given to secured lenders in the reorganization process.

Implications for Lenders

Secured lenders are obviously concerned about obtaining the real value of their collateral when the borrower files for bankruptcy.

The *Philadelphia Newspapers* opinion, while not binding outside of the Eastern District of Pennsylvania, builds on the Fifth Circuit's decision in *Pacific Lumber* and, together, those decisions may signal a changing tide with respect to the level of control given to secured lenders in the reorganization process.

In light of the different factual underpinnings of *Philadelphia Newspapers* and *Pacific Lumber*, the former should serve as a more serious concern for secured lenders. If *Philadelphia Newspapers* is upheld on appeal,[15] it could drastically alter the level of control that both secured creditors and debtors have over the bankruptcy process.

Secured creditors will likely prefer sales under §363, rather than under a plan, in order to maintain their right to credit bid. Debtors and unsecured creditors will prefer a plan process where they can essentially choose the winning bid, and leverage such control to extract concessions from the secured creditors that they would not otherwise be able to obtain under §363.

1. *In re Philadelphia Newspapers, LLC*, 2009 U.S. Dist. LEXIS 104706 (E.D. Pa., Nov. 10, 2009) (hereinafter "*Philadelphia Newspapers*").
2. *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009) (hereinafter "*Pacific Lumber*"), discussed infra.
3. 11 U.S.C. §363(k).
4. Cram down refers to a plan that has been rejected by a class entitled to vote on it, and the debtor seeks to confirm the plan notwithstanding the class's rejection.
5. 11 U.S.C. §1129(b)(2)(A). The indubitable equivalent standard derives from Judge Learned Hand's opinion in *Metropolitan Life Ins. Co. v. Murel Holding Corp. (In re Murel Holding Corp.)*, 75 F.2d 941, 942 (2d Cir. 1935). "Judge Hand concluded that the creditor's right to 'get his money or at least the property' may be denied under a plan for reorganization only if the debtor provides a 'substitute of the most indubitable equivalence.' Such a substitute clearly must both compensate for present value and insure the safety of the principal." *In re American Mariner Indus. Inc.*, 734 F.2d 426, 433 (9th Cir. 1984).
6. *In re River Vall.*, 181 B.R. 795 (E.D. Pa. 1995); *H&M Parmely Farms v. Farmers Home Admin.*, 127 B.R. 644 (D.S.D. 1990); *In re SunCruz Casinos, LLC*, 298 B.R. 833 (Bankr. S.D. Fla. 2003); *In re Kent Terminal Corp.*, 166 B.R. 55 (Bankr. S.D.N.Y. 1994); *In re Orfa Corp.*, 1991 WL 225985 (Bankr. E.D. Pa. Oct. 31, 1991); *In re 222 Liberty Assocs.*, 108 B.R. 971 (Bankr. E.D. Pa. 1990); *In re Realty Invs., Ltd. V*, 72 B.R. 143 (Bankr. C.D. Cal. 1987).
7. *Philadelphia Newspapers*, 2009 U.S. Dist. LEXIS 104706 at *58.
8. *In re Criimi Mae Inc.*, 251 B.R. 796, 807-08 (Bankr. D. Md. 2000).
9. *In re Philadelphia Newspapers, LLC*, 2009 Bankr. LEXIS 3167 (Bankr. E.D. Pa., Oct. 8, 2009) (hereinafter "*Bankruptcy Court Decision*").
10. *Pacific Lumber*, 584 F.3d at 248.
11. *Bankruptcy Court Decision*, 2009 Bankr. LEXIS 3167 at *26.
12. *Philadelphia Newspapers*, 2009 U.S. Dist. LEXIS 104706 at *61-62 n.23.
13. 124 Cong. Rec. H11, 14 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17420 (daily ed. Oct. 6, 1978) (remarks of DeConcini).
14. *Bankruptcy Court Decision*, 2009 Bankr. LEXIS 3167 at *30-31.
15. On Nov. 18, 2009, the U.S. Court of Appeals for the Third Circuit ordered a stay of the auction while it considers the appeal. That hearing is currently scheduled for Dec. 15, 2009.