

## Bankruptcy, Restructuring and Creditors' Rights Client Service Group

To: Our Clients and Friends

March 30, 2010

### Third Circuit Rules Secured Lender Not Entitled to Credit Bid at Sale of Collateral Under a Cramdown Plan

On March 22, 2010, the Third Circuit in a split decision joined the Fifth Circuit in holding that a debtor may sell its assets under a plan of reorganization without permitting a secured lender to credit bid by offsetting its secured claim against the purchase price.<sup>1</sup> This decision may have major implications for secured lenders and may lead to more contested confirmation hearings and litigation over valuation, particularly in cases where the secured lender's liens are disputed or the plan does not provide for a sale of all of the debtor's assets.

In the chapter 11 bankruptcy case of Philadelphia Newspapers, LLC, *et al.* (the "Debtors"), pending before the United States Bankruptcy Court for the Eastern District of Pennsylvania, the Debtors proposed a plan of reorganization (the "Plan") that incorporated a sale of substantially all of the Debtors' assets under §§ 1123(a)(5)(D) and 1129(b)(2)(A)(iii) of the Bankruptcy Code. The proposed terms of the sale required a cash bid for the assets and prohibited the secured lenders (the "Lenders") from credit bidding. The Lenders opposed the sale and argued that §1129(b)(2)(A)(ii) required credit bidding. The Debtors argued that they could proceed under §1129(b)(2)(A)(iii), which did not require granting the Lenders a right to credit bid, but merely required that the Lenders receive the "indubitable equivalent" of their secured interest under the Plan. The Debtors asserted that giving the Lenders a specified cash payment, any proceeds from the auction of the assets in excess of the stalking-horse bid and a deed to the Debtors' real property (subject to a two-year, rent-free lease for the purchaser) constituted the "indubitable equivalent" of the Lenders' claims. The Bankruptcy Court issued an order disallowing the bar on credit bidding by the Lenders. *In re Philadelphia Newspapers, LLC*, NO. 09-11204, Slip Op. (Bankr. E.D.Pa. Oct. 8, 2009). The Bankruptcy Court reasoned the while the sale would proceed under subsection (iii) of §1129(b)(2)(A), it was structured as a sale under subsection (ii) in every respect other than disallowing credit bidding. Reading §1129(b)(2)(A) in light of Bankruptcy Code §§ 363(k) and 1111(b), the Bankruptcy Court held that the Lenders must be allowed to credit bid their debt in a sale of the Debtors' assets. The Bankruptcy Court's ruling was appealed to the District Court, and on November 10, 2009 the District Court reversed the Bankruptcy Court decision, holding that the Bankruptcy Code does not entitle secured lenders to credit bid in a sale pursuant to a plan of reorganization. *In re Philadelphia Newspapers, LLC*, No. 09-mc-178, Slip. Op.

<sup>1</sup> *Citizens Bank of Pa. v. Phila. Newspapers, LLC (In re Phila. Newspapers, LLC)*, 2010 WL 1006647 (3d Cir. Mar. 22, 2010) (No. 09-4266, Docket No. 003110067889).

(E.D.Pa. Nov. 10, 2009). The Lenders appealed the District Court's order to the Third Circuit Court of Appeals.

The Third Circuit affirmed the District Court's decision and rejected the Lenders' arguments that a sale conducted pursuant to a plan of reorganization must be approved under § 1129(b)(2)(A)(ii), holding that the Lenders had no legal right to credit bid at the auction and that the Bankruptcy Code "unambiguously permits a court to confirm a reorganization plan so long as secured lenders are provided the 'indubitable equivalent' of their secured interest." Maj. Op. at 5. The Third Circuit reasoned that "Congress' inclusion of the indubitable equivalence prong intentionally left open the potential for yet other methods of conducting asset sales, so long as those methods sufficiently protected the secured creditors' interests." Maj. Op. at 22. Moreover, requiring an asset sale pursuant to a plan of reorganization to comply with the requirements of subsection (ii) "significantly curtails the ways in which a debtor can fund its reorganization—an outcome at odds with the fundamental function of the asset sale, to permit debtors to 'provide adequate means for the plan's implementation.'" Maj. Op. at 23. Citing the Fifth Circuit's decision in *Pacific Lumber*, the Third Circuit determined that since §1129(b)(2)(A) was written in the disjunctive it should be read to provide alternatives, and is not exhaustive of the ways in which a debtor might satisfy the "fair and equitable" requirement for confirming a plan over the objection of its secured lenders. Maj. Op. at 24; *In re Pacific Lumber Co.*, 584 F.3d 229, 245 (5th Cir. 2009).

In contrast to the *Pacific Lumber* decision, the Third Circuit did not determine whether the Lenders' treatment under the plan satisfied the "indubitable equivalent" standard. Accordingly, the Third Circuit stated that it made no determination as to whether the auction would generate were the "indubitable equivalent" of the Lenders' interest in the Debtors' assets, and that the Lenders are free to argue at confirmation of the Plan that the auction did not generate sufficient proceeds to satisfy the standard. The Third Circuit also noted that there may be circumstances in which the "indubitable equivalent" standard cannot be met and credit bidding would be required. Maj. Op. at 43; *Pacific Lumber*, 584 at 246-47.

Judge Ambro, a former bankruptcy lawyer, issued a strong dissent. He stated that "if credit bidding is denied ... the debtors' insiders stand to benefit by having more leverage to steer the sale to a favored purchaser (here, the Stalking Horse Bidder)." Dis. Op. at 4. Judge Ambro concluded that the majority opinion was inconsistent with §§ 363(k) and 1111(b) of the Bankruptcy Code and with Congress' intention to protect secured lenders at an asset sale pursuant to a plan of reorganization by providing them "a means to control undervaluations of secured assets." Dis. Op. 48.

Precluding a secured lender's right to credit bid at the sale of its collateral under a plan may leave the secured lender exposed in two material respects: First, the secured lender's objection to the sale may now hinge upon whether the secured creditor can persuade the bankruptcy court at a plan confirmation hearing that the proposed plan does not provide the secured lender with the "indubitable equivalent" of its interest. As a practical matter, this issue is likely to arise only in those cases where the plan proposes to sell less than all of its assets, since if there are no remaining assets left following the sale to which a substitute lien could attach the ability of the debtor to argue that the secured lender has received the indubitable equivalent would seem to be precluded. Second, the secured lender may be forced to participate in bidding at a bankruptcy auction to protect its collateral from being sold at an unreasonably low value. Given the current economic climate, cash bidding at auction may be highly problematic for secured lenders having limited liquidity, limited availability of cash resources, or a secured lending consortium which is diverse in both its present participants and their respective capital resources, particularly if it is unclear if the proceeds of the sale will ultimately be paid to the secured lender should it prevail at the auction.

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To discuss this issue further, please speak to your Bryan Cave contact, or to:

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