Philadelphia District Court Rejects Secured Lenders' Right to Credit Bid

On November 10, 2009, the District Court issued a significant decision in the *Philadelphia Newspapers, LLC* bankruptcy case that, if upheld, materially reduces the rights of secured lenders to realize the value of their collateral. *See In re Philadelphia Newspapers, LLC*, No. 09-mc-178 (E.D. Pa. Nov. 10, 2009). The District Court decided that in certain cases involving a bankruptcy sale, lenders may be precluded from credit bidding. This decision follows a similar Fifth Circuit opinion issued weeks earlier in the *Pacific Lumber Co.* bankruptcy case. *See In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009). These decisions, representing an erosion of a lender's right to credit bid in a bankruptcy sale, will not be the final word on this issue. The Third Circuit Court of Appeals has already entered an order staying the auction in *Philadelphia Newspapers* and expediting the appeal. The Third Circuit will entertain oral arguments in this matter on December 15, 2009.

Facts of the Case

The Debtors operate 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 their assets. The Debtors' indebtedness exceeded $300 million as of the bankruptcy filing. Neither the amount of the indebtedness nor the validity of the Senior Lenders' liens have been challenged.

Unable to restructure their indebtedness under the loan documents through negotiations with the Senior Lenders, the Debtors filed for bankruptcy protection. In the bankruptcy, the Debtors secured 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. Under this proposal, the Senior Lenders were prevented from credit bidding.

Relevant Statutory Provisions

The tension arises in this case because 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 in *Philadelphia Newspapers* asserted that section 1129(b) of the Bankruptcy Code allows a debtor to bypass section 363(k) and obtain approval of a sale in which a secured lender is 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).

Opinion of the District Court

The issue on appeal was 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 cramdown the Senior Lenders. This prong requires that

secured creditors receive the "indubitable equivalent" of their claim. "Indubitable Equivalent" is a judicially-created concept which was incorporated into the Bankruptcy Code in 1978. This term has 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, which 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 ruled that section 1129(b)(2)(A) required that the Secured Lenders be permitted to credit bid. 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."[1]

The *Philadelphia Newspapers* decision comports 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.

Practical Implications of the Recent Decisions Rejecting a Lender's Right to Credit Bid

The import of the *Philadelphia Newspapers* and *Pacific Lumber* decisions is that a secured creditor can no longer presume that it will have an absolute right to acquire its collateral in a bankruptcy proceeding by credit bidding its debt. The Bankruptcy Code's protection of the right of a secured creditor to have the value of its secured position maintained throughout a bankruptcy proceeding has been upended. The Bankruptcy Code provides a secured creditor several protections with respect to its collateral ― including the section 363(k) credit bid right and the section 1111(b) election,[2] the latter of which is inapplicable in the context of a sale. These decisions effectively allow a debtor to circumvent both of these protections

[1] Due to the procedural posture of the *Philadelphia Newspaper* bankruptcy, the District Court expressly qualified its holding on two separate occasions in the decision. *See In re Philadelphia Newspapers, LLC*, No. 09-mc-178 at 35, 55. Specifically, the District Court clarified that its holding was limited in time to a point prior to confirmation and limited in effect to a pre-confirmation auction. The District Court further clarified that its decision did not "address whether denying the right to credit bid under the circumstances satisfies the fair and equitable or indubitable equivalent standards under section 1129." And therefore, the District Court stated, the "Senior Lenders retain the right to argue at confirmation, if appropriate, that the restriction on credit bidding failed to generate fair market value at the Auction, thereby preventing them from receiving the indubitable equivalent of their claim."

[2] Section 1111(b) of the Bankruptcy Code allows an undersecured creditor to elect to have its deficiency claim treated as a fully secured claim. If a secured creditor makes a section 1111(b) election, then a plan of reorganization must provide that a secured creditor will receive payments equal to the total amount of the secured creditor's claims with such payment obligation having a present value equal to the current value of the secured creditor's collateral.

where a secured lender's collateral is sold pursuant to a plan. If upheld, the ability of the Debtors to skirt these protections creates a significant risk to secured lenders, because, without the ability to credit bid or make an election under section 1111(b), a secured lender is foreclosed from participating in the collateral's upside. This risk may alter the calculus lenders consider in extending and pricing future loans. While these decisions, if upheld, may preclude a lender from asserting that it has an absolute right to credit bid when its collateral is being sold pursuant to a plan of reorganization or that a sale of its collateral without a provision setting forth its right to credit bid violates the absolute priority rule or the fair and equitable standard, these decisions do not foreclose such objections as an absolute rule. Both the *Philadelphia Newspaper* and the *Pacific Lumber* courts contemplated that, in some instances, credit bidding may be required. In fact, a review of both cases reveals that valuation will play a key role in any objection based on a violation of the absolute priority scheme or the fair and equitable standard. In addition, with respect to a fair and equitable objection, a lender can still maintain that the absence of a credit bid did not provide such lender the benefit of its bargain (in other words, the lender was not provided the "indubitable equivalent") because, among other reasons, the lender was stripped of the ability to participate in the upside of its collateral. This determination will be decided on a case-by-case basis.

Chicago Office
+1.312.583.2300

Frankfurt Office
+49.69.25494.0

London Office
+44.20.7105.0500

Los Angeles Office
+1.310.788.1000

New York Office
+1.212.836.8000

Shanghai Office
+86.21.2208.3600

Washington, DC Office
+1.202.682.3500

West Palm Beach Office
+1.561.802.3230