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The decision is particularly significant because it is from the Court of Appeals that sets precedent for bankruptcies in Delaware, a state in which many significant bankruptcy cases are filed.

Debtors May Preclude Secured Lenders from Credit Bidding in a Free-and-Clear Sale in a Chapter 11 Cram-Down Plan

March 26, 2010

The United States Court of Appeals for the Third Circuit, in a decision announced March 22, 2010, ruled that a chapter 11 debtor may evade the secured lenders' protection of credit bidding at a sale of their collateral through a cram-down chapter 11 plan.[1] The court permitted such a plan under section 1129(b)(2)(A)(iii) of the Bankruptcy Code, as long as the secured lenders receive the "indubitable equivalent" of their claims. The decision is particularly significant because it is from the Court of Appeals that sets precedent for bankruptcies in Delaware, a state in which many significant bankruptcy cases are filed. The decision could substantially increase the risk to secured creditors of undervaluation of collateral in bankruptcy asset sales, reduce the amount of secured lenders recoveries and depress the trading value of distressed leveraged loans.

BACKGROUND

Section 1129 of the Bankruptcy Code permits a debtor to confirm a chapter 11 plan by "cramming down" the plan over the objection of creditors 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 a cram-down of secured lenders to be fair and equitable, section 1129(b)(2)(A) requires that the plan must provide (i) that the secured lenders retain their liens and receive deferred cash payments totaling at least to the value of the collateral securing their claims, (ii) for the sale, subject to the secured lenders' ability to credit bid, of the collateral free and clear of the secured lenders' liens, with such liens attaching to the proceeds of the sale, or (iii) that the secured lenders receive the "indubitable equivalent" of their claims.[3]

The Debtors, Philadelphia Newspapers LLC, along with eight affiliates, filed a chapter 11 plan in which they proposed to sell substantially all of their assets free and clear of any interests in a public auction pursuant to bidding procedures that precluded their secured lenders (the "Lenders") from credit bidding their claims. Instead, the Debtors insisted that any qualified bidder fund its purchase with cash. Simultaneously, the Debtors entered into a "stalking horse" asset purchase agreement with Philly Papers, LLC, an entity that was controlled by the Debtors' former management and equity holders. Under the plan, the Lenders would receive $37 million cash, the Debtors' headquarters building (which the Debtors valued at $29.5 million), subject to a two-year rent free lease for the entity that purchased the assets, and any cash generated by a higher bid at a public auction. The Debtors argued that the sale satisfied clause (iii) of section 1129(b)(2)(A) because the Lenders would receive the "indubitable

[1] *In re Philadelphia Newspapers LLC*, No. 09-4266 (3d Cir. March 22, 2010).

[2] 11 U.S.C. § 1129(b)(1).

[3] Indubitable equivalence is a concept unique to bankruptcy law that is derived from a 1935 Second Circuit decision by Judge Learned Hand. The Bankruptcy Code does not contain a definition of "indubitable equivalent"; rather, the "indubitable equivalent" standard has been developed through caselaw. As the *Pacific Lumber* court noted, the phrase is "rarely explained in caselaw, because most contested reorganization plans follow familiar paths outlined in Clauses (i) and (ii) [of section 1129(b)(2)(A)]". *In re Pacific Lumber Co.*, 584 F.3d 229, 246 (5th Cir. 2009).

equivalent" of their claims under the plan, which totalled over $318 million. The Lenders objected to the plan, arguing that section 1129(b)(2)(A) requires that all sales of assets free and clear of liens must permit credit bidding.

DECISION

The Bankruptcy Court rejected the Debtors' proposed bidding procedures, reasoning that section 1129(b)(2)(A), when analyzed in the context of other sections of the Bankruptcy Code, requires that any sale of a debtor's assets free and clear of liens under a chapter 11 plan must allow secured lenders to credit bid. The United States District Court for the Eastern District of Pennsylvania reversed the Bankruptcy Court, and the Court of Appeals affirmed.

The Court of Appeals, relying heavily on a plain meaning interpretation and a recent Fifth Circuit decision,[4] concluded that the three clauses of section 1129(b)(2)(A) list possible alternatives under which a plan may be considered to be "fair and equitable" and therefore be confirmable. Because the three options are separated by the disjunctive word "or", the court reasoned that each clause represented a distinct and independent method by which a plan may be confirmed over the objection of a class of secured creditors. Although the second clause specifically mandates the presumptive right[5] to credit bid in a free and clear sale of assets, the court found that a free and clear sale without credit bidding could still be permissible under the third clause as long as the sale provides the "indubitable equivalent" of the Lenders' claims. The court interpreted the term "indubitable equivalent" to be purposefully broad to allow for flexibility in formulating chapter 11 plans and not to require credit bidding in every free and clear asset sale. Moreover, the court found that its decision did not directly contradict the overall structure of and legislative intent behind the Bankruptcy Code's treatment of secured creditors. Even though it held that the Lenders did not have an absolute right to credit bid in a sale under a plan, it did, however, note that "a lender can still object to a plan confirmation [on the basis that] the absence of a credit bid did not provide it with the 'indubitable equivalent' of its collateral", seemingly inviting the Bankruptcy Court to undo the outcome the Court of Appeals felt compelled to reach as a matter of statutory interpretation.[6]

In an extensive dissent, Judge Thomas Ambro argued that there was more than one reasonable reading of the statute and that it had to be interpreted by reference to other provisions of the Bankruptcy Code, and in light of the statute's legislative history and the overall structure of the Bankruptcy Code. Based on such an analysis, he argued that the three clauses of section 1129(b)(2)(A) describe three exclusive and "distinct routes that apply specific requirements depending on how a given plan proposes to treat the claims of secured creditors".[7] As such, any plan that proposes a free and clear asset sale must presumptively allow for credit bidding, as is required in the second clause, and should not be permitted under the "indubitable equivalent" prong of section 1129(b)(2)(A)(iii).

EFFECT OF THE DECISION

This decision, coupled with the recent Fifth Circuit decision *In re Pacific Lumber Co.*, marks a significant departure from long-held expectations of secured creditors and could endanger protections traditionally thought to be afforded to them under the Bankruptcy Code.

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[4] *In re Pacific Lumber Co*., 584 F.3d 229 (5th Cir. 2009). Although decided on similar grounds, the decision in *Pacific Lumber* related to a different procedural situation from the one in *Philadelphia Newspapers. Pacific Lumber* dealt with an appeal of the confirmation of a plan involving a free and clear asset sale that precluded credit bidding, while *Philadelphia Newspapers* was an appeal of the bankruptcy court order disapproving bidding procedures that precluded credit bidding (*i.e.*, before the asset sale had actually taken place).

[5] It is a presumptive right, because the "court [can] for cause order[] otherwise" under section 363(k).

[6] *Philadelphia Newspapers*, at *43-44.

[7] *Id.* at *16 (Ambro, J., dissenting).

the dissent, as a result of this decision, debtors that wish to preclude secured creditors from credit bidding (because, for example, they are unduly influenced by existing equity holders or other insiders) are more likely to try to sell their assets in a sale under a chapter 11 plan rather than through a sale under section 363. This could represent a significant erosion of secured creditor protections under the Bankruptcy Code, as credit bidding is an important safeguard that ensures against the undervaluation of collateral in an asset sale. As Judge Ambro points out in his dissent, "while many of the valuation mechanisms (such as judicial valuation or a market auction) may theoretically result in a perfect valuation, Congress has provided the credit bid mechanism as insurance for secured creditors to protect against an undervaluation of the assets sold. Secured creditors who believe their collateral is being sold for too low a price may bid it higher and use as credit the dollars they have already extended . . . to the debtors".[8] The loss of the important check on valuation that the ability to credit bid provides would be a significant adverse development for secured creditors.

This construct will likely lead to higher litigation costs and possibly reduced recoveries as secured creditors who are denied the ability to credit bid may have to litigate valuation issues as part of the confirmation process, as opposed to having valuation determined through an open auction process.

As the dissent points out, the only party that stands to benefit from an undervaluation of the assets is the purchaser, in this case, most likely the stalking horse bidder "with substantial insider and equity ties".[9] It also argues that the majority improperly shifted the burden on the issue of the availability of credit bidding from the debtors to the creditors, leaving the secured creditors "with only a belated court inquiry at confirmation to determine whether the denial of credit bidding was 'fair and equitable' to [them]".[10] This construct will likely lead to higher litigation costs and possibly reduced recoveries as secured creditors who are denied the ability to credit bid may have to litigate valuation issues as part of the confirmation process, as opposed to having valuation determined through an open auction process. Ultimately, the decision may depress the trading value of distressed leveraged loans, because of the increased risk to chapter 11 recoveries, and could have the unwelcome (from the perspective of secured lenders) consequence of making it easier for debtors to structure transactions in a manner that benefits existing equity and other insiders at the expense of secured creditors.

We expect secured lenders to use at least three tactics to mitigate the effects of this decision. First, they may litigate the issues left open by the decision — whether the plan is actually fair and equitable and provides the indubitable equivalent of their claims. Litigation is likely to center on independent valuation and the Supreme Court's 1999 decision[11] casting a jaundiced eye toward insider plans that attempt to cram-down secured lenders. Second, they may, if they are providing debtor-in-possession financing or consenting to use of cash collateral, attempt to negotiate limits on the kind of plan the debtor may file. Finally, when available, they may use a daylight loan[12] to permit a "cash" bid at the auction. The mere presence of the ability to use a daylight loan may take away the debtor's leverage in proposing a cash-only auction.

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[8] *Id.* at *33-34 (Ambro, J., dissenting).

[9] *Id.* at *44 (Ambro, J., dissenting).

[10] *Id.* at *34 n.18 (Ambro, J., dissenting).

[11] *In re 203 N. La Salle St. P'ship*, 526 U.S. 434 (1999).

[12] A loan that is drawn on the closing date to fund the purchase and is repaid on the same day from the proceeds of the secured lenders' distributions under the plan.