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## WEATHERING THE STORM Third Circuit Ruling on Credit Bidding is Bad News for Lenders

On March 22, 2010, the Third Circuit released its long-awaited ruling in the *Philadelphia Newspapers* case regarding the applicability of credit bidding. In *Philadelphia Newspapers*, the proposed plan of reorganization provided for a sale of assets free of the liens of the secured creditors without allowing the secured creditors to credit bid on the assets.<sup>1</sup> The court concluded that subsection (iii) of §1129(b)(2)(A) of the Bankruptcy Code, which contains no statutory right to credit bid, unambiguously permits a debtor to proceed with any plan that provides secured lenders with the “indubitable equivalent” of their security interest in the asset.

The plan of reorganization in *Philadelphia Newspapers* provided that substantially all of the debtors’ assets would be sold at a public auction free and clear of liens. Simultaneously, the debtors signed a stalking horse agreement with a proposed buyer controlled by insiders of the debtor. The lenders were extremely under-secured, and it was anticipated that the sale would generate approximately \$37 million for the lenders. In addition, the lenders would receive the Philadelphia headquarters of the debtors, which the debtors valued at \$29.5 million, subject to a two-year rent free lease for the purchaser. The bid procedures order precluded the lenders from credit bidding their secured claims at the auction sale.

The court concluded that the language of §1129(b)(2)(A) was unambiguous and that it provided for three independent circumstances for confirming a plan over the objection of secured creditors. Subsection (i) provides that secured creditors retain their liens if the debtor retains or transfers the collateral, and for deferred cash payments to the secured creditors. Subsection (ii) provides for the sale of the collateral free and clear of liens with the opportunity for the lender to credit bid on the property in accordance with §363(k), which allows the secured lender to credit bid at a sale of the collateral “unless the court for cause orders otherwise.” Subsection (iii) provides for the lenders’ realization of the “indubitable equivalent” of their claims.

The statutory language separates subsections (i), (ii), and (iii) by the word “or,” thus indicating that each subsection is independently available to a debtor. Because the *Philadelphia Newspapers* plan proposed treatment of the secured creditors’ collateral based on the indubitable equivalent provision in subsection (iii), which does not refer to credit bidding, the court determined that the secured creditors were not entitled to credit bid.

Although it is a well-settled maxim that specific statutory provisions prevail over general provisions, the court concluded that subsection (ii), which specifically provides for sale of the collateral and credit bidding, did not operate as a limitation on the broader indubitable equivalent language of subsection (iii). Application of the broader catchall provision of subsection (iii) did not make the narrower sale provision of subsection (ii) superfluous. To read the statute otherwise would significantly curtail the ways in which a debtor can fund its reorganization. The Third Circuit discussed the recent Fifth Circuit decision in *Pacific Lumber*<sup>2</sup>, which confirmed a plan that cashed out a secured lender at the collateral’s court-determined value, without permitting the secured lender to credit bid at the sale of its collateral. The *Pacific Lumber* court also ruled that the cash payment to the secured lender was the indubitable equivalent of the secured lender’s claim. The Third Circuit concluded that because the *Philadelphia Newspapers* plan had not yet been confirmed, the court was not yet in a position to determine if the consideration to be provided to the secured lenders

<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).

<sup>2</sup> *Bank of N.Y. Trust Co., NA v. Official Unsecured Creditors’ Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009).

was the indubitable equivalent of their claims and that the secured lenders were free to contest the debtor's plan at confirmation.

The court held that the lenders could not elect treatment as fully secured claimants under §1111(b) if the collateral is to be sold under the plan and that the Bankruptcy Code does not provide the secured creditor with an absolute entitlement to credit bid because even if the collateral is sold under subsection (ii), or in a §363 sale, the court can prohibit credit bidding "for cause," such as to ensure the success of the reorganization or to foster a competitive bidding environment. The secured creditor is not entitled to benefit from the eventual appreciation of the collateral.

Although the Third Circuit concluded that reference to the legislative history was not necessary, it noted that a secured creditor did not have the right to make the §1111(b) election if the property was transferred under subsection (i) subject to the secured creditor's lien or if the sale was without credit bidding rights "for cause," either in a §363 sale or pursuant to subsection (ii), and determined that its reading of the statute was not demonstrably at odds with the legislative intent.

The concurring opinion agreed that the secured lenders could not credit bid, but stated that because the statute was unambiguous, reference to the legislative history was not necessary.

Judge Thomas Ambro<sup>3</sup> wrote a strong dissent. He pointed out that the debtors had engaged in a high stakes, extensive advertising campaign promoting the message "keep it local," apparently a reference to the stalking horse bidder, largely composed of insiders, as the favored suitor. He noted the "game" the debtors were playing by providing for two years of free rent in the building that the debtors were ostensibly surrendering to the lenders and the perception that the plan was designed to favor the stalking horse bidder, and not to produce the highest and best offer. Judge Ambro felt that the stalking horse bidder is seeking to pay as little as possible to obtain the assets "on the cheap" and exploit the coordination difficulties of the lenders in a large syndicated loan that might prevent the lenders from "writing a check to themselves."

After discussing the rationale for credit bidding to balance the rights of debtors and secured creditors, Judge Ambro concluded that credit bidding chills cash bidding no more than the presence of a deep-pocketed bidder at an auction. He noted that there are several provisions of the Bankruptcy Code where the word "or," when read in context with alternative options, rendered the options exclusive, such as §365(g)(2)(B), which authorizes assumption of an executory contract before or after conversion. Subsection 1129(b)(2) contains specific "requirements" for treatment of creditors, and subsection 1129(b)(2)(A) "provides" for the treatment of secured claims. Invoking the canon of statutory construction that specific provisions prevail over general provisions, Judge Ambro concluded that clause (ii), which specifically deals with sales free and clear of liens, precluded the use of the indubitable equivalent provisions of clause (iii) and that the use of clause (iii) for sales free and clear would render clause (ii) superfluous.

Judge Ambro also read the sale provisions of §1129(b)(2)(A) in the context of §1111(b) and §363k and determined that, if read together, the availability of credit bidding avoids undervaluation at a sale free and clear of liens. Sections 1129(b)(2)(A)(ii) and 1111(b) are alternative protections for the secured creditor: one to apply when the collateral is sold free and clear of liens and the other to apply when the collateral is treated other than as a sale. This is the only reading of the statute that is consistent with the legislative history, which states that "sale of property under section 363 or under the plan is excluded from treatment under section 1111(b) because of the secured party's right to bid in the full amount of his allowed claim at any sale of the collateral under section 363k...".

<sup>3</sup> Prior to becoming a Third Circuit judge, Ambro was a well known bankruptcy lawyer in Delaware.

After analyzing the statutory provisions and the legislative history, Judge Ambro concluded that the specific provisions of §1129(b)(2)(A)(ii) preclude the use of the catchall indubitable equivalent provision of §1129(b)(2)(A)(iii) and that the secured lenders should have the right to credit bid at the *Philadelphia Newspapers* auction. He noted that the majority opinion did not prevent the lenders from opposing confirmation of the plan at the confirmation hearing on the grounds that the treatment of the secured lenders did not provide them with the indubitable equivalent of their claims. Judge Ambro also pointed out that the debtors' plan was a thinly veiled attempt for insiders to retain control of an insolvent company minus the debt burden the insiders incurred in the first place.

The *Philadelphia Newspapers* decision, along with the Fifth Circuit decision in *Pacific Lumber*, open up new avenues for creative thinking by debtors and potential buyers and create new and difficult problems for secured creditors who believe that their collateral has been undervalued in a Chapter 11 case.

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