

## Third Circuit Affirms Debtor's Right to Nix Credit Bidding in Sale Under Chapter 11 Plan

On March 22, 2010, the United States Court of Appeals for the Third Circuit affirmed<sup>1</sup> a decision of the Eastern District of Pennsylvania which reversed a Pennsylvania Bankruptcy Court and allowed a debtor to preclude its lender from credit bidding at a sale of the debtor's assets under a proposed chapter 11 plan. The chain of decisions emanates from the *Philadelphia Newspapers* bankruptcy case, currently pending in the Bankruptcy Court for the Eastern District of Pennsylvania.

Credit bidding is the right of a secured creditor, such as a mortgagee, to bid at the sale of its collateral with the credit of the indebtedness owed to it and secured by the collateral, rather than with cash. It is a right generally recognized in a foreclosure sale and in a sale of assets in a bankruptcy case that occurs outside of a chapter 11 plan. While a creditor can also be permitted to credit bid in a sale of collateral pursuant to a chapter 11 plan, the issue for the Third Circuit was whether such plan had to allow for credit bidding.

### Background and Lower Courts' Rulings

The Debtors, which own and operate print and online newspapers, including the *Philadelphia Inquirer* and the *Philadelphia Daily News*, filed a chapter 11 plan of reorganization that contemplates the sale of substantially all of the Debtors' assets at a public auction. The Debtors signed an asset purchase agreement with an entity owned by an insider of the Debtors that agreed to act as the opening, or "stalking horse" bidder. Shortly thereafter, the Debtors filed a motion for approval of bidding procedures relating to the sale. The bidding procedures specifically precluded the lenders from credit bidding at the auction. The lenders, the official committee of unsecured creditors, and other creditors objected to the sale motion.

In seeking to block the credit bidding, the Debtors relied on one of the alternatives in the Bankruptcy Code for getting a plan of reorganization put into effect, even if secured creditors reject the plan. Such provisions are nicknamed "cram down" provisions, and there are three alternatives for treating the claims of secured creditors. The first alternative, which was not at issue, is the restructuring of the secured

debt with a new maturity, interest rate and amortization schedule. The second alternative is the sale of the collateral with the right to credit bid. The Debtors invoked the third alternative, which simply requires that the secured creditor receive the "indubitable equivalent" of its claim.<sup>2</sup> The Debtors argued that they could propose a plan sale without credit bidding as long as they gave their lenders the "indubitable equivalent" of their secured claims.

The Bankruptcy Court disallowed the Debtors' proposed terms and required that the procedures allow the lenders to credit bid. Reading the language of the "cram down" provisions as indivisible, the Court reasoned that even though the plan stated that it was proceeding under the "indubitable equivalent" prong, the plan contained a sale process, and so had to meet the requirements of the "sale" prong. Therefore, the Court determined that the lenders must be allowed to credit bid.

The District Court reversed the Bankruptcy Court's decision, holding that there is no legal entitlement in the Bankruptcy Code to credit bid at an auction pursuant to a plan. Rather, the cram down provisions offer three distinct routes to confirmation from which the debtor can select, and each route is to be interpreted separately. Since the right to credit bid was incorporated into subsection (ii), but not subsection (iii), debtors proceeding under subsection (iii) are not required to allow lenders to credit bid, the Court held.

### The Third Circuit's Analysis

The Third Circuit, in its majority decision generating three separate opinions, upheld the District Court's reasoning and determined that the plain meaning of the cram down provisions permits a debtor to conduct an asset sale without allowing for credit bidding. The lenders argued that statutory construction rules require that specific provisions trump broader ones. Thus, even though the three applicable subsections are disjunctive, only subsection (ii) deals with the sale of assets in a plan, and since subsection (ii) incorporates the credit bidding provisions of the Bankruptcy Code, the debtor cannot preclude it. The Court dismissed this argument, stating that the plain language of the statute

provides that the plan must be fair and equitable to the secured claimants, and allows the debtor a choice of options to reach that fair and equitable outcome. Since the Debtors had chosen option (iii), and option (iii) contains no requirement to allow credit bidding, the Debtors can preclude it. The Third Circuit left it up to the Bankruptcy Court to determine, at confirmation, whether the lenders will receive the “indubitable equivalent” of the value of their claims, and thus have been treated fairly and equitably – if so, such a plan will satisfy the requirements of the statute and can be confirmed.

The Court further concluded that the term “indubitable equivalent” is not ambiguous or incapable of definition. Rather, while broad in scope, it has a distinct meaning – the “unquestionable value of a lender’s secured interest in the collateral.” A debtor can employ a variety of means to provide the indubitable equivalent of the lender’s claim – a cash payout, a replacement lien, abandonment of the property – and thus there is no requirement to force credit bidding.

Finally, Circuit Judge Fisher, a former Pennsylvania legislator and state Attorney General who wrote for the majority, addressed the argument that the plain meaning of the statute is at odds with Congressional intent. The lenders argued that the Bankruptcy Code guarantees a secured lender either the right to treat its deficiency claim as fully secured or the right to credit bid. Since the Bankruptcy Code does not allow recourse lenders whose collateral is to be sold to elect the fully secured treatment, such lenders must be given the right to credit bid. Judge Fisher disagreed, stating that, by operation of the Code itself, this argument must fail, because the Code contemplates situations where neither option is afforded a lender, such as when the statute empowers the court to deny the right to credit bid “for cause.”

## The Dissent

Judge Ambro, an eminent bankruptcy lawyer before his appointment to the Court, dissented and reasoned instead that the context and history of the Bankruptcy Code lead “to the conclusion that the Code requires cramdown plan sales free of liens to meet the specific requirements of [the sale alternative] and not the general requirement of [the indubitable equivalent alternative].” To allow otherwise would give the debtor’s insiders leverage by allowing them

the ability to steer the sale in favor of a preferred purchaser to the detriment of the lender. Judge Ambro asserted that the debtor cannot simply pick and choose which of the disjunctive list under the cram down alternatives it wishes to satisfy. Rather, these are “distinct routes that apply specific requirements depending on how a given plan proposes to treat the claims of secured creditors.” Primarily, the dissent adopted the lenders’ argument that specific provisions trump general ones, particularly stressing that clause (iii) cannot apply if clauses (i) or (ii) would otherwise apply, as it would render the other clauses superfluous. Moreover, Judge Ambro asserted that Congress deemed the ability to credit bid so important that secured creditors have that ability in sales through plans as well as sales by other methods.

## Ramifications

*Philadelphia Newspapers* will have a major impact on secured lenders’ rights in the Third Circuit, and elsewhere if its rationale is followed. Giving the debtor the ability to preclude credit bidding in a sale of its assets through the construct of a plan will very likely, as Judge Ambro cautioned, give the debtor much greater leverage over its secured lenders and afford it the ability to steer sales toward a preferred buyer. Lenders are not completely left in the lurch, however. The opinion gives them the ability to argue at confirmation that they did not in fact receive the “indubitable equivalent” of their claims and any other applicable “fair and equitable” issues may still be in play.

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<sup>1</sup> *In re Philadelphia Newspapers, LLC*, \_\_\_ F.3d \_\_\_, 2010 WL 1006647 (3rd Cir. March 22, 2010).

<sup>2</sup> The three alternatives are set out in 11 U.S.C. § 1129(b)(2)(A)(i), (ii) & (iii).

<sup>3</sup> 2010 WL 1006647 at \*2.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.* at \*5-6.

<sup>6</sup> 11 U.S.C. § 363(k).

<sup>7</sup> 2010 WL 1006647 at \*9.

<sup>9</sup> *See* 11 U.S.C. § 1111(b).

<sup>10</sup> The election under section 1111(b) is not available to recourse lenders when the property is sold. 11 U.S.C. § 1111(b)(1)(B)(ii).

<sup>11</sup> 2010 WL 1006647 at \*14; 11 U.S.C. § 363(k).

<sup>12</sup> *Id.* at \*17.