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The Philadelphia Story: Third Circuit Denies Lenders' Credit-Bid Rights

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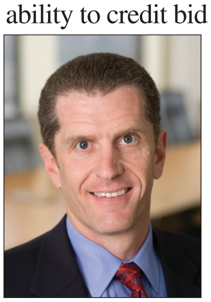
Editor's Note: *The lenders in the case discussed herein have filed a motion with the Third Circuit Court of Appeals seeking a rehearing* en banc. *At the time of publication, the motion had not yet been ruled upon.*

In a much-anticipated decision, the Third Circuit Court of Appeals has ruled that a secured creditor does not have a statutory right to credit-bid on a sale of its collateral under a proposed plan of reorganization. This ruling in the *Philadelphia Newspapers* chapter 11 cases paves the way for an auction of the debtors' newspaper properties under a proposed plan of reorganization, while depriving the vastly undersecured senior lenders of the ability to credit bid on their collateral.



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In our previous article in the March 2010 issue of the *ABI Journal*, we discussed the ruling of the bankruptcy court, which refused to approve proposed plan sale procedures denying lenders their credit-bidding right, and the decision of the district court, which reversed the bankruptcy court, concluding that plan sale procedures that omitted a credit-bidding right did not, as a matter of law, render a plan unconfirmable.[1] On appeal to the Third Circuit, a sharply divided three-judge panel affirmed the district court, with the majority holding that the plain language of §1129(b)(2)(A) allows a debtor to propose a sale of a secured creditor's collateral under a plan free and clear of liens without providing the creditor a right to credit-bid, so long as the sale provides the secured creditor with the indubitable equivalent of its claim.[2] In a well-reasoned dissent, Judge Thomas Ambro strongly disagreed with the majority's holding, arguing that the plain language of the statute did not compel the result reached by the district court and the majority.[3] With this decision, the Third Circuit joins the Fifth Circuit in its *Pacific Lumber* decision in holding that sale plans without credit-bidding rights may be confirmable under §1129(b)(2)(A).[4] This article will explore the Third Circuit opinion and dissent, and analyze the ramifications of the decision on future chapter 11 plan confirmation battles.

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Feature

Background

The debtors acquired the newspaper assets in July 2006 for $515 million. The debtors financed a portion of that purchase with a $295 million secured loan from a group of lenders pursuant to a loan agreement granting the lenders first-priority liens and security interests in substantially all of the debtors' real and personal property.[5] As of the date of the proposed plan, the outstanding amount under the loan had increased to approximately $318 million.[6] In September 2008, the debtors defaulted on their payment obligations under the loan agreements, and in 2009 the debtors filed chapter 11 petitions.[7]

In August 2009, the debtors filed a joint chapter 11 plan of reorganization providing for a proposed sale of substantially all of the debtors' assets free and clear of liens.[8] The proposed sale was to be conducted by a public auction with a stalking-horse bidder made up, in part, of certain of the debtors' equity-holders.[9]

The stalking-horse bidder proposed to pay approximately $37 million in cash for the assets, the bulk of which was to be paid to the lenders. In addition, the debtors proposed to convey certain real property (valued by the debtors at $29.5 million) to the lenders.[10] Importantly, that real property came with a big catch: The property was encumbered with a two-year, rent-free lease in favor of the entity that would ultimately operate the newspapers.[11] Finally, the plan provided

1 Eric W. Anderson and Joshua J. Lewis, "The Impact of Philadelphia Newspapers on a Secured Creditor's Right to Credit Bid," *Am. Bankr. Inst. Journal*, Vol. XXIX, No. 2 (March 2010).

2 *In re Philadelphia Newspapers LLC, et al.*, 2010 U.S. App. LEXIS 5805 (3d Cir. March 22, 2010).

3 *Id.* at **57, *et seq.*

4 *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009).

5 *Id.* at *3.

6 *Id.*

7 *Id.* at *4.

8 *Id.*

9 *Id.*

10 *Id.* at **4-5.

11 *Id.* at *5.

that any excess cash generated for the assets through the public auction would be paid to the lenders.[12]

Prior to plan confirmation, the debtors sought approval of bid procedures requiring bidders to fund any purchase of the assets with cash in order to become qualified bidders, which had the effect of precluding the lenders from credit-bidding.[13] The lenders, who openly expressed their intent to credit bid at the sale, opposed the bid procedures on the grounds that the Bankruptcy Code granted the lenders a right to credit-bid. In response, the debtors argued that because the sale was being conducted pursuant to a plan of liquidation authorized under §1123, and not under §363 of the Bankruptcy Code, the lenders did not have a right to credit-bid.[14]

The focus of the parties' argument over the approval of the debtors' proposed bid procedures turned to whether the sale plan prohibiting the lenders from credit-bidding would be rendered unconfirmable if the lenders voted against the plan or whether the plan could satisfy the cramdown requirements under §1129.[15] The lenders contended that because the plan called for a sale of substantially all of the assets, the debtors must seek confirmation under the sale prong of §1129(b)(2)(A)(ii), which expressly incorporates the right to credit-bid under §363(k). The debtors countered that the plan was being proposed under §1129(b)(2)(A)(iii) and that the plan could be crammed down over the lenders' objection as long as the lenders received the "indubitable equivalent" of their claims. The bankruptcy court agreed with the lenders and held that the bid procedures for any sale of the debtors' assets under a plan must allow for credit bidding by the lenders.[16] The bankruptcy court therefore approved bidding procedures allowing the lenders to bid their secured debt up to an amount in excess of $318 million.[17]

The debtors appealed that decision, and the district court reversed the bankruptcy court, holding that §1129(b)(2)(A) did not guarantee the lenders an absolute right to credit-bid in a sale of assets under the proposed plan.[18] In so ruling, the district court applied a "plain language" analysis to the statute and held that the three alternate routes for plan confirmation under the "fair and equitable" test of §1129(b)(2)(A) were independent prongs, separated by the disjunctive "or," and therefore each was sufficient for confirmation of a plan as "fair and equitable" under the Code.[19] The district court reasoned that Congress intended for debtors to craft creative solutions to the treatment of a secured creditor's claim and that so long as such treatment provided the secured creditor with the indubitable equivalent of its claim, the plan could be confirmed, even if that treatment entailed a plan sale with no credit bidding rights.[20]

The Third Circuit's Opinion

On appeal by the lenders, the Third Circuit affirmed the district court, holding that §1129(b)(2)(A) "unambiguously permits a court to confirm a reorganization plan so long as secured creditors are provided the 'indubitable equivalent' of their secured interest."[21] The majority opinion relied heavily on the plain language of the statute and found that the disjunctive "or" in §1129(b)(2)(A) means that "a debtor may proceed under subsection (i), (ii) or (iii), and need not satisfy more than one subsection."[22] The court stated firmly that "any doubt as to whether subsections (i), (ii), and (iii) were meant to be alternative paths to meeting the fair and equitable test of §1129(b)(2)(A) is resolved by the Bankruptcy Code itself, and courts have followed this uncontroversial mandate."[23]

The majority opinion dismissed the lenders' argument—based on the statutory construction maxim that specific statutory provisions should prevail over more general provisions—that a plan sale can only be authorized under §1129(b)(2)(A)(ii).[24] After exploring Supreme Court and other precedent construing that maxim of statutory construction, the court found that the "specific vs. general" rule was inapplicable in evaluating §1129(b)(2)(A), concluding that although "subsection (ii) specifically refers to a 'sale' and incorporates a credit-bid right under §363(k), we have no statutory basis to conclude that it is the only provision under which a debtor may propose to sell its assets free and clear of liens."[25] Applying the same reasoning, the Third Circuit determined that Congress included the indubitable equivalent prong in the cramdown provisions to allow debtors to develop other methods of conducting asset sales, so long as the secured creditor's interests could be protected in such sales.[26]

Having held the plain meaning of §1129(b)(2) to be unambiguous, the Third Circuit addressed and dismissed the lenders' argument that the court should review legislative history to further evaluate congressional intent in passing the statute.[27] The court also disposed of the lenders' arguments that the denial of a lender's right to credit-bid conflicted with congressional intent as expressed through the interplay among the §1111(b) election for nonrecourse creditors, the credit-bid rights of secured creditors under §363(k), and §1129.[28]

While this decision made it clear that in the Third Circuit sale plans prohibiting secured creditors from credit-bidding are confirmable, the court made it equally clear that its limited holding did not address whether the plan proposed by the debtors otherwise satisfied §1129 by providing the lenders with the indubitable equivalent of their claim: "We are simply not in a position at this stage to conclude, as a matter of law, that this auction cannot generate the indubitable equivalent of the lenders' secured interests in the [d]ebtors' assets."[29]

In what may be one of the more important, but less visible, discussions in the case, the court evaluated the import of the use of the term "indubitable equivalent" in the cramdown statute. Noting that the term "indubitable equivalent" may be "infrequently employed in popular parlance, [it] was not plucked from the congressional ether,"[30] the Third Circuit discussed that Congress frequently employs broad language (like "indubitable equivalent") to avoid the necessity of attempting to spell out every contingency that might occur, and use of such broad language does not make a statute ambiguous.[31] The Third Circuit concluded that finding the term "indubitable equivalent" under §1129(b)(2)(A)(iii) means "the unquestionable value of a lender's secured interest in the collateral."[32] This interpretation, while not vital to the court's ultimate decision, may significantly limit the scope of the lenders' arguments at confirmation. The court's determination that the term "indubitable equivalent of such claim" is purely a

12 *Id.*
13 *Id.*
14 *Id.*
15 *See generally In re Philadelphia Newspapers LLC*, 2009 Bankr. LEXIS 3167, 2009 WL 3242292 (Bankr. E.D. Pa.), *rev'd*, 418 B.R. 548 (E.D. Pa. 2009).
16 *Id.* at **6-7.
17 *Id.* at *7.
18 *Id.* at **7-8.

19 *Id.* at *8.
20 *Id.*
21 *Id.* at *2.
22 *Id.* at *15.
23 *Id.* at **15-16. In arriving at its conclusion, the Third Circuit cited *Pacific Lumber Co.*, 584 F.3d at 245, wherein the Fifth Circuit likewise interpreted the disjunctive language in §1129(b)(2)(A) to mean that a sale plan could be fair and equitable, even if it deprived a secured lender of the right to credit-bid, as long as the lender received the indubitable equivalent upon its claim.
24 *Id.* at **19-24.
25 *Id.* at *23.

26 *Id.*
27 *Id.* at *51.
28 *Id.* at **51-54.
29 *Id.* at ** 38, 53.
30 *Id.* at *30.
31 *Id.*
32 *Id.* at *32.

quantitative question of valuation seems to preclude any more qualitative arguments from the lenders that, for instance, a sale plan without credit-bidding rights deprives the lenders of the benefit of their contractual bargain and therefore cannot constitute the indubitable equivalent of their claim.

Judge Smith concurred with the majority opinion, but only insofar as the majority applied the plain-meaning rule. Judge Smith did not join the majority opinion with respect to its attempt to determine that the plain meaning of §1129(b)(2) was not inconsistent with congressional intent. Thus, the holding of the two-judge majority was simply that, under the plain meaning of §1129(b)(2)(A), a sale plan denying a secured creditor the right to credit-bid could be confirmed.[33]

Judge Ambro's Dissent

For those secured lenders in jurisdictions outside of the Third Circuit unhappy with the decision in *Philadelphia Newspapers,* some solace can be found in the well-reasoned, lengthy dissent of Judge Ambro, who disagreed with the majority's conclusion that §1129(b)(2)(A) is unambiguous. Judge Ambro likewise disagreed with the conclusion of Judge Fisher, the author of the majority opinion, that the denial of a secured creditor's right to credit-bid in sale plans was consistent with congressional intent and the Bankruptcy Code as a whole. Judge Ambro characterized the debtors' attempt to keep the lenders from credit-bidding as a "high-stakes game of chicken" dictated by the stalking-horse bidder, which was largely composed of and controlled by the current and former management and equityholders of the debtors, to obtain the assets "on the cheap."[34]

Judge Ambro, like the bankruptcy court, found that a full reading of the Bankruptcy Code leads to the inescapable conclusion that Congress intended for secured lenders' right to credit-bid to be preserved except in extraordinary circumstances, for instance when a court "for cause" denies a secured creditor's right to credit-bid under §363(k).[35] Ambro conceded that the three subsections of §1129(b)(2)(A) were indeed joined by the disjunctive "or," but argued that the majority's noncontextual reading of that "or" would "become the bell, book, and candle that excommunicates congressional intent from the Bankruptcy Code."[36]

Judge Ambro reasoned that allowing a debtor to sell assets free and clear of liens under a plan using the indubitable-equivalent prong renders subsections (i) and (ii) of §1129(b)(2)(A) meaningless, because any debtor not wishing or able to comply with the requirements of those subsections simply would choose the indubitable-equivalent prong and therefore sidestep the very protections Congress intended by enacting §1129(b)(2)(A)(ii), the sale prong of the cramdown statute.[37] Under the necessary corollary to the "plain language" canon of statutory construction that a court should not adopt an interpretation of a statute that renders any portion of the statute meaningless, Judge Ambro found the majority's "plain meaning" of §1129 not so plain and indeed contrary to congressional intent as evidenced by the language of the statute.[38] In Ambro's opinion, Congress intended for the sale prong to be "exclusively applicable" to plan sales of assets free and clear of liens, reasoning that Congress had specifically provided for a potential sale plan in §1129(b)(2)(A)(ii).[39]

Ramifications of the Third Circuit's Decision

Now the Fifth Circuit and the Third Circuit have adopted a plain-language reading of §1129(b)(2)(A) to allow a debtor to propose a sale plan without affording secured creditors the right to credit-bid. Whether one agrees with the decisions or not, the law appears to be established in these circuits for the foreseeable future. Without a conflict in the circuits, it seems unlikely that this matter is ripe for adjudication by the Supreme Court.

It is almost certain that these decisions will have an effect on relationships between debtors and secured creditors in cases going forward. In his dissent, Judge Ambro suggested that the majority's ruling may result in higher lending costs for borrowers as secured creditors price new risks into their lending decisions based on their perceived inability to receive the benefit of their bargain by credit bidding for their own collateral in a bankruptcy case. The court's ruling may also affect DIP financing and cash colleratal negotiations. Lenders will seek to secure their credit-bidding rights with the consent of the debtor early on in a case by conditioning the use of cash collateral or funds advanced under a DIP loan upon the debtor not filing a sale plan that deprives the lender of credit-bidding rights. Of course, courts may not approve any DIP order or cash-collateral order restricting a debtor's ability to file and confirm a plan, but it seems reasonable for a DIP lender to insist that submission of a plan proposing to deny credit-bidding would constitute a default under the DIP facility or cash-collateral order.

As we noted in our previous article, the other certain outcome of *Philadelphia Newspapers* is that secured creditors must be prepared to argue and demonstrate with evidence that a sale plan that does not afford them credit-bidding rights does not satisfy the indubitable-equivalent test. The Third Circuit was careful to highlight that it was only deciding the limited procedural question of whether, as a matter of law, a proposed sale plan denying credit-bidding rights under the indubitable-equivalent prong of §1129(b)(2)(A) is unconfirmable. A significant and no doubt heated battle remains at the confirmation hearing as to whether the debtors can demonstrate as a matter of fact that the result reached at the auction provides the lenders with the indubitable equivalent of their claim.

In addition to challenging the auction results based on the value received at the sale, the lenders might also argue that their "claim" consists of their full bundle of rights against the debtors and their collateral, and, outside of bankruptcy, a critical component of their claim was the ultimate ability to foreclose upon and take back their collateral. Under this argument, denial of credit-bidding could not truly be the indubitable equivalent of the lenders' claim because the right to credit is a key benefit of the lenders' prepetition bargain. As noted above, however, the Third Circuit's holding that "indubitable equivalent" is purely a valuation concept may severely hamper a lender's ability to mount such an attack by apparently limiting the issue at confirmation to one of quantitative value.

With asset sales seemingly the norm in chapter 11 cases today, *Philadelphia Newspapers* and *Pacific Lumber* certainly seem to tilt the playing field away from lenders and in favor of debtors and purchasers. ■

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33 *Id.* at **57, *et seq.*
34 *Id.* at **59, 61.
35 *Id.* at *117.
36 *Id.*
37 *Id.* at **93-94.
38 *Id.*
39 *Id.*