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## Secured Lenders Do Not Have An Absolute Right to Credit Bid Their Claims in Bankruptcy Sales Under a Plan

On March 22, 2010, the Third Circuit Court of Appeals in the *Philadelphia Newspapers* case affirmed the District Court's decision to approve proposed bid procedures denying secured lenders the right to credit bid their claims in connection with a sale of their collateral under a chapter 11 plan of reorganization. Normally, secured creditors are given the opportunity to credit bid the full value of their secured claims at auctions of their collateral, which typically occur under section 363 of the Bankruptcy Code. Lending institutions in particular should take heed of the Third Circuit's decision in assessing both their lending practices and enforcement strategies in chapter 11 bankruptcy cases.

### FACTS

In the *Philadelphia Newspapers* case, a group of financial institutions extended a \$295 million loan to Philadelphia Newspapers, LLC, which was secured by first liens on substantially all of the company's assets. Philadelphia Newspapers defaulted on loan covenants and failed to make loan payments, and thereafter it and certain of its affiliates filed voluntary chapter 11 cases in the Bankruptcy Court for the Eastern District of Pennsylvania.

Several months later, the debtors filed a chapter 11 plan of reorganization that called for the sale, free and clear of all liens, of substantially all of the debtors' assets pursuant to a public auction. The plan proposed that the secured lenders would receive (a) \$37 million in cash, plus additional cash reflecting the difference, if any, between the winning bid at the auction and the initial "stalking horse" bid, and (b) the debtors' former headquarters (subject to a two-year rent-free lease to the entity that would operate the newspapers going forward), which was valued at \$29.5 million. At the same time they filed the plan, the debtors entered into an asset purchase agreement with a proposed bidder controlled by certain of the debtors' insiders who agreed to purchase the debtors' assets. The debtors also filed a motion for approval of bidding procedures for the proposed auction, and those procedures required that all bids be in cash and prohibited any credit bidding of claims.

The secured lenders objected to the bidding procedures arguing that the plan could not be confirmed over the lenders' opposition unless the plan was "fair and equitable" under section 1129(b)(2)(A) of the Bankruptcy Code. To be "fair and equitable," the lenders asserted that the bidding procedures had to permit them to credit bid up to the full amount of their claim in connection with the proposed sale of their collateral. The Bankruptcy Court agreed with the secured lenders and rejected the proposed bidding procedures.

## DISTRICT COURT RULING

On appeal, the District Court reversed the Bankruptcy Court and held that the bidding procedures should be approved. The District Court held that Bankruptcy Code section 1129(b)(2)(A) provides three distinct avenues for finding that a plan is "fair and equitable" as to a secured lender. Relying on section 1129(b)(2)(A)'s disjunctive language, the District Court held that a plan need only satisfy one of the following requirements in order to pass muster: (i) the secured lender retains its liens on collateral and receives deferred cash payments, (ii) the secured lender's liens attach to the proceeds of a sale free and clear of liens, and that such sale be subject to a secured lender's right to credit bid as provided under section 363(k) of the Bankruptcy Code, or (iii) the secured lender receives the "indubitable equivalent" of its claim. In this case, the District Court held that the proposed bidding procedures relating to the sale of the lender's collateral could result in it receiving indubitably equivalent value, thus potentially satisfying the third prong of section 1129(b)(2)(A).

## COURT OF APPEALS RULING

In affirming the District Court's decision, the Third Circuit, in a two to one decision, also engaged in a statutory interpretation analysis of section 1129(b)(2)(A) and concluded that subsection (ii) is not the sole point of reference for cram down in a sale of secured property free of liens. The Third Circuit held that a plan may be confirmed under subsection section 1129(b)(2)(A)(iii) so long as the secured party receives the "indubitable equivalent" of its claims. Again agreeing with the District Court, the Third Circuit held that (a) the statute was clear and unambiguous and (b) because "or" is disjunctive, the three clauses of section 1129(b)(2)(A) provide alternative grounds on which a plan may be found to be "fair and equitable."

Notably, one of the Third Circuit judges wrote a lengthy dissent arguing that a free and clear sale under a plan must comply with the specific requirements of subsection (ii) which include a secured lender's right to credit bid. In reaching this conclusion, the judge asserted that section 1129(b)(2)(A) is ambiguous and statutory interpretation requires that a specific term prevail over a more general term. The dissenting judge also raised concerns about the impact that the majority view may have on lending practices, suggesting that lenders may increase borrowing costs if their right to credit bid can be eliminated under a chapter 11 plan.

We discussed the *Philadelphia Newspapers* case at a March 19 panel discussion on section 363 sales held in our New York offices. During that panel discussion, which occurred three days before the Third Circuit's decision was announced, we noted the impact that the majority's position could have on lending practices and a secured lender's enforcement strategy in chapter 11. We suggested that if a secured lender's right to credit bid can be stripped away in a plan/sale context, secured creditors may consider more aggressive enforcement strategies in order to protect themselves in the period leading up to confirmation. This could include seeking relief from the stay, requesting adequate protection, placing onerous restrictions on the use of cash collateral, or other similar actions. Although the ultimate impact of the Third Circuit's decision in *Philadelphia Newspapers* remains unknown, we are certain that the decision will garner widespread interest from lenders, borrowers and other parties involved in lending transactions.

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