Bankruptcy & Restructuring Law Monitor
PROVIDING COMMENTARY AND THE LATEST UPDATES ON BANKRUPTCY & RESTRUCTURING LAW
PUBLISHED BY
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Third Circuit Holds Section 1129(b)(2)(A) of the Bankruptcy Code Does Not Provide Secured Lenders With a Legal Entitlement to Credit Bid at an Auction Sale Pursuant to a Plan of Reorganization

Posted at 8:40 AM on March 25, 2010 by Ryan T. Jareck

Does a secured creditor have an absolute right to acquire its collateral, which is sold pursuant to a plan of reorganization, by credit bidding its debt? The Third Circuit Court of Appeals, in a strict constructionist opinion, has just answered this question in the negative.

The Court of Appeals in In re Philadelphia Newspapers, LLC, No. 09-4266 (3d Cir. March 22, 2010) upheld the decision of the United States District Court for the Eastern District of Pennsylvania (which reversed the Bankruptcy Court's ruling) that barred the prepetition secured lenders from credit-bidding their secured claim to purchase the assets of Philadelphia Newspapers L.L.C. (the "Debtor") pursuant to the Debtor's plan of reorganization. The Debtor and other related affiliate-debtors own and operate The Philadelphia Inquirer, Philadelphia Daily News, and philly.com (the "Assets"), which they acquired for $515 million in July 2006 with the proceeds of a $295 million loan from a syndicate of lenders (the "Lenders"). The Lenders hold a first priority lien on substantially all of the Debtor's Assets, and are owed approximately $319 million. The Debtor proposed a Chapter 11 plan of reorganization (the "Plan") providing for the sale of the Assets at a public auction free and clear of all liens, claims and encumbrances. Simultaneously, the Debtor entered into a stalking horse purchase agreement with Philly Papers, LLC, an insider of the Debtor, and sought, through its proposed bidding procedures, to preclude the Lenders from credit bidding at the public

auction (i.e., all bids had to be in the form of cash).

The Third Circuit was asked to decide whether the District Court correctly held that Section 1129(b)(2)(A) of the Bankruptcy Code does not provide secured lenders with a legal entitlement to credit bid at an auction sale pursuant to a plan of reorganization. The Third Circuit, as did the District Court, relied on the plain language of the statute, which "provides three distinct routes to plan confirmation – retention of liens and deferred cash payments under subsection (i), a free and clear sale of assets subject to credit bidding under subsection (ii), or provision of the "indubitable equivalent" of the secured interest under subsection (iii)." These three alternatives were independent and, therefore, proceeding under either of them was sufficient for confirmation of a plan as "fair and equitable" under the Bankruptcy Code. Because subsection (iii), unlike subsection (ii), does not incorporate the right to credit bid, a debtor who seeks confirmation under the third alternative is not required to allow credit bidding.

In so ruling, the Third Circuit agreed with the Fifth Circuit's decision in In re Pacific Lumber Co., 584 F.3d 229 (5th Cir. 2009), and distinguished its holding in In re SubMicron Systems Corp., 432 F.3d 448 (3d Cir. 2006). The Court found that SubMicron, which holds that a lender in a Section 363(b) sale could bid up to the full value of its loan and the credit bid sets the value of the lender's secured interest in collateral, does not equate to a holding that a credit bid must be the successful bid at a public auction. Rather, a court is called at the plan confirmation stage to determine whether a lender has received the "indubitable equivalent" of its secured interest in the collateral. In other words, it is the plan of reorganization, and not the auction itself, that must generate the "indubitable equivalent." The Third Circuit noted that, notwithstanding its ruling, secured lenders still retain their rights to argue at confirmation that the absence of a credit bid fails to provide them with the "indubitable equivalent" of their collateral.

Judge Thomas Ambro, a former bankruptcy judge, dissented. Judge Ambro reasoned that to read subsection (iii) to accomplish a sale free of liens, but without following the specific procedures prescribed by subsection (ii), undoubtedly places the two clauses in conflict. He expressed serious concern that the majority's ruling effectively eviscerated

the rights afforded to and expectations of secured lenders, and forecasted the adverse impact the ruling would have on the availability and pricing of future credit. Given the prevalence of credit bidding in Chapter 11 cases today, the Third Circuit's opinion will have a significant ripple effect.

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