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Secured Creditors Are Not Entitled to Credit-Bid in a Sale Through a Reorganization Plan

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Philadelphia Newspapers LLC and its related debtor entities, as debtors and debtors-in-possession (the debtors), proposed a plan of reorganization that included, among other things, the sale of substantially all of their assets by public auction pursuant to §363 of chapter 11 of title 11 of the U.S. Bankruptcy Code. The plan contemplated that a stalking-horse bidder, comprised of several equity investors, would submit a cash bid in the amount of \$30 million, which would be used to pay down the more than \$300 million of secured debt that the debtors owed to their senior secured lenders (the lenders). The reorganization plan further contemplated an additional \$36 million distribution to the lenders in the surrender of real property—leaving the lenders with an approximately \$244 million shortfall.

In accordance with the reorganization plan, the debtors sought approval of bidding procedures that required all bids to be in cash. Citing §§1123(a) and (b) and 1129 of the Code, the bid procedures prohibited the lenders from credit-bidding their debt, and with the \$244 million shortfall, supplied significant motivation to oppose the sale.^[1]

In their objection to the bid procedures, the lenders argued that the court could not confirm the plan over their objection unless the lenders were provided the right to credit-bid at the auction. The lenders cited numerous Code provisions, but most notably §§363(k) and 1111(b), that when read together, support the concept that secured creditors are entitled to protection from underbidding.^[2] In contrast, the debtors argued that §1129(b)(2)(A)(iii) permitted them to cram down a plan on the lenders by providing the lenders with the “indubitable equivalent” of their claim. The debtors argued that they could rely on any one of the three prongs identified in this Code section—the last of which is the indubitable equivalent standard—to satisfy the fair and equitable test and cram down the plan on the lenders.

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At the first level of this dispute, the U.S. Bankruptcy Court for the Eastern District of Pennsylvania found in the lenders' favor. It looked to several "integrated provisions of the [B]ankruptcy [C]ode (e.g., §§367, 1111, 1123 and 1129)" and held that "where an undersecured creditor's collateral is proposed to be sold, whether under §363 or under a plan, the secured creditor is entitled in all events to protect its rights in its collateral, either by making an election under §1111(b) or by credit bidding its debt." *In re Philadelphia Newspapers*, No. 09-mc-178, 2009 U.S. Dist. LEXIS 104706 at *13 (E.D. Pa. Nov. 10, 2009) (emphasis in original).

On appeal, the U.S. District Court for the Eastern District of Pennsylvania held that the lenders were not entitled to credit-bid. The district court reasoned that, unlike §363, a sale pursuant to §1123(a)(5)(D) does not provide secured lenders with a right to credit-bid, and therefore, the lenders did not have an absolute right to credit-bid. The district court next analyzed another section that references credit bidding—11 U.S.C. §1129(b)(2)(A), known as the cramdown provision.

Section 1129(b)(2)(A) sets forth three scenarios under which a plan is "fair and equitable" and may be used to cram down nonconsenting secured creditors. This section provides that a plan is fair and equitable if secured creditors: (1) retain their lien and receive deferred cash payments totaling at least the value of the allowed claim; (2) have the right to credit bid, in a sale subject to §363(k); or (3) receive the "indubitable equivalent" of their claim. The district court read these requirements disjunctively and held that each individual prong can be used to support a finding that a plan is fair and equitable. According to the district court, since the debtors relied on the indubitable-equivalent prong, they did not need to provide the lenders with a right to credit-bid.

The district court was careful to state that its ruling only dealt with a narrow pre-confirmation question—not the ultimate issue of "whether denying the right to credit-bid under the circumstances satisfies the fair and equitable standard or indubitable equivalent standards under section 1129." *Id.* at *69 (emphasis in original). That question will be left for the lenders to argue at confirmation.

Commentary

In holding that the lenders do not have a right to credit-bid in a sale of their collateral pursuant to a plan, the district court arguably stripped away the Code provisions that Congress inserted to protect secured lenders from the risk of low bids—likely the circumstance here—and questionable judicial valuations. These wrongs are the very things that §§363(k) and 1111(b) were enacted to prevent. It is not the last word, however. The Third Circuit Court of Appeals stayed the auction pending appeal, and heard oral argument in December 2009, but even if the district court's decision is upheld, confirming a plan of reorganization under the indubitable-equivalent prong of the Bankruptcy Code's cramdown provision can be a dubious proposition. Either way, the outcome of the *Philadelphia Newspapers* case will impact how sales and plans are formulated in the future.

1. Credit-bidding permits a secured creditor to bid up to the face amount of its debt without putting up cash or cash equivalents, instead receiving a cash credit for the face amount of their debt with which to bid. Credit Bidding permits a secured creditor to retain its collateral as the winning bidder or receive a cash payout from the bidding process. It is codified in §363(k) of the Code.

2. Section 1111(b) gives an undersecured creditor the option to elect to retain a postpetition lien on its collateral. An electing creditor must receive deferred cash payments that at least equal the value of the secured portion of its claim. Because the lender retains the lien, if the value of the collateral increases after the consummation of a plan of reorganization, the creditor will receive the benefits of the collateral's increased value when it is later sold or the loan is paid off.

Without the §1111(b) election, an undersecured creditor's claim would be split into two claims: (1) a secured claim that will have to be satisfied in order for a plan to be confirmed; and (2) an unsecured claim placed in a general unsecured pool.

