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Denying Secured Creditors the Right to Credit Bid in Chapter 11 Cases and the Risk of Undervaluation

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Articles

Denying Secured Creditors the Right to Credit Bid in Chapter 11 Cases and the Risk of Undervaluation

ALAN N. RESNICK*

The Bankruptcy Code has reached a delicate balance between protecting the rights of secured creditors and providing financially troubled companies with flexibility in reorganizing their businesses. One protection that has been available to secured creditors is the right to “credit bid” at any sale of collateral free of liens, which allows the creditor to buy the property by offsetting its claim against the purchase price instead of paying cash. This right is designed to assure that property is not sold free of security interests at a price that is below the collateral’s true value. An inadequate sales price deprives the creditor of the full benefit of its security interest. The importance of credit bidding has grown as asset sales have become more common in chapter 11 cases.

*Despite the universal view during the past three decades that the right to credit bid was essentially guaranteed when property is sold under a chapter 11 plan, two recent controversial decisions—the Fifth Circuit’s decision in *In re Pacific Lumber Co.* and the Third Circuit’s decision in *In re Philadelphia Newspapers, LLC*—curtailed this protection by holding that a secured lender may be denied the right to credit bid when its collateral is sold under a chapter 11 plan if the bankruptcy court makes a judicial finding that the creditor will realize the “indubitable equivalent” of its secured claim without credit bidding.*

*These recent circuit court decisions have shifted the balance between the rights of lien holders and the rights of financially troubled borrowers in a way that affords less protection to secured creditors and greater flexibility to chapter 11 debtors. This Article analyzes these cases and discusses the impact these decisions will have on the chapter 11 sale process, creditor expectations and behavior, and the cost and availability of credit. This Article will also discuss the recent Seventh Circuit decision in *River Road Hotel Partners, LLC v. Amalgamated Bank*, which rejected the Third Circuit’s reasoning in *Philadelphia Newspapers*, thereby causing a circuit split. The Supreme Court, which granted certiorari to review the Seventh Circuit decision, is likely to resolve these important issues soon.*

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INTRODUCTION

A goal of chapter 11 of the Bankruptcy Code is the preservation of value of a distressed company through reorganization or a sale of the company's assets. This goal often conflicts with property rights of entities that are not in bankruptcy. In striving to save businesses, thereby saving jobs and maximizing recovery for creditors, the Bankruptcy Code has reached a delicate balance between the protection of property rights of

lien holders and the maximization of value for the benefit of all stakeholders in the enterprise.

The protection of property rights in a bankruptcy case is not merely a matter of legislative preference or economic policy. In *Louisville Joint Stock Land Bank v. Radford*, the Supreme Court held that a prebankruptcy security interest in property of a debtor is constitutionally protected by the Fifth Amendment.¹ Since that landmark decision, courts have held that impairment of a secured creditor's lien position by reason of the bankruptcy laws constitutes an impermissible taking of property without just compensation.²

The constitutional protection of property rights does not mean, however, that secured creditors are unscathed during the reorganization process. In furthering its value-maximization and reorganization policies, the Bankruptcy Code infringes on the rights of secured creditors in a number of ways. For example, the automatic stay under section 362(a) prohibits foreclosure by a secured creditor upon the debtor's default,³ a right the secured creditor would have under applicable state law.⁴ A secured creditor also may have to tolerate the debtor's substitution of its collateral with other property.⁵ A secured creditor on a debt that matured before the filing of the bankruptcy petition also may be compelled under a plan of reorganization to accept deferred cash payments over a period of several years with interest at a rate that is lower than the rate applicable in the absence of bankruptcy.⁶ All of these impositions on a secured creditor's rights in the debtor's property, among others, can be achieved over the objection of the secured creditor. As the Supreme Court has written:

Property rights do not gain any *absolute* inviolability in the bankruptcy court because created and protected by state law. Most property rights are so created and protected. But if Congress is acting within its bankruptcy power, it may authorize the bankruptcy court to affect these property rights, provided the limitations of the due process clause are observed.⁷

1. 295 U.S. 555, 589 (1935) ("The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment.").

2. See, e.g., *Chem. Bank v. Am. Kitchen Foods, Inc.* (*In re Am. Kitchen Foods, Inc.*), 2 Bankr. Ct. Dec. 715, 719 (Bankr. D. Me. 1976).

3. 11 U.S.C. § 362(a) (2010).

4. U.C.C. § 9-601(a)(1) (2011).

5. The Bankruptcy Code recognizes that a secured creditor may be "adequately protected" by receiving an additional or replacement lien in other property to the extent of any decrease in value of the original collateral. See 11 U.S.C. § 361(2) (2010).

6. See *id.* § 1129(b)(2)(A)(i).

7. *Wright v. Union Cent. Life Ins. Co.*, 304 U.S. 502, 518 (1938) (emphasis added). The Court quoted from *Wright v. Vinton Branch of the Mountain Trust Bank*, 300 U.S. 440, 470 (1937), referring to its holding in *Van Huffel v. Harkelrode*, 284 U.S. 225, 227 (1931):

Despite provisions of the Bankruptcy Code that alter secured creditors' rights, the Code contains provisions designed to assure the adequate protection of the secured creditor's interest in collateral consistent with the Fifth Amendment mandate. Indeed, the right to adequate protection of its lien is given a higher priority than the reorganization policy. For example, a secured creditor has an absolute right to relief from the automatic stay to foreclose on its collateral if the debtor fails to provide the secured creditor with adequate protection of its lien.⁸ Similarly, the continued use of the collateral by the debtor must be prohibited, conditioned, or modified to the extent that such use will deprive the lien holder of adequate protection.⁹ Thus, if collateral is depreciating, the automatic stay must be terminated or modified, or the debtor's use of the collateral must be prohibited or limited, unless the trustee or debtor in possession makes periodic cash payments, grants a replacement lien, or provides some other means of assuring that the creditor will realize the "indubitable equivalent" of its lien.¹⁰ The Code requires the termination of the automatic stay to permit foreclosure by a secured creditor based on the lack of adequate protection, regardless of whether such relief will destroy any prospects for a successful reorganization of the debtor and the adverse consequences that may result from such termination.¹¹

Particular challenges in balancing the rights of lienors and the reorganization policy occur when creditors are undersecured because the value of collateral is less than the amount of the debt. In general, if the value of the collateral is less than the amount of the debt, under section 506(a)(1) of the Bankruptcy Code, the creditor's claim is treated as a secured claim up to the value of the collateral and as an unsecured claim for the deficiency.¹² The secured claim has a higher priority in the distribution scheme in bankruptcy with respect to its collateral, while unsecured claims often realize only pennies on the dollar.

In view of such bifurcation, a potential danger faced by secured creditors in chapter 11 cases is the risk that the collateral will be

A court of bankruptcy may affect the interests of lien holders in many ways. To carry out the purposes of the Bankruptcy Act, it may direct that all liens upon property forming a part of the bankrupt's estate be marshalled; or that the property be sold free of encumbrances and the rights of all lien holders be transferred to the proceeds of the sale.

Wright, 300 U.S. at 470.

8. 11 U.S.C. § 362(d)(1) (requiring the bankruptcy court to grant a party's request for relief from the automatic stay for cause, including the lack of adequate protection of the party's property interest).

9. *See id.* § 363(e).

10. *See id.* § 361.

11. *See* 3 COLLIER ON BANKRUPTCY ¶ 362.07[3][b] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

12. *See* 11 U.S.C. § 506(a)(1) (2010).

undervalued, thus depriving the creditor of the full benefit of its lien. Such undervaluation could arise in a number of contexts. For example, if a secured creditor moves for relief from the automatic stay on the ground that its collateral is depreciating and is not adequately protected, the court could conduct a hearing and make a determination as to the value of the collateral. Much ink has been spilled over the proper way for courts to value collateral, but regardless of the methodology employed in a judicial valuation, such valuation is not an exact science and is subject to error.¹³

The most accurate method for determining the value of collateral is to conduct a true market test in the form of a public auction with court-approved bidding procedures designed to attract the highest and best offer. As the Supreme Court said in *Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*, “[u]nder a plan granting an exclusive right, making no provision for competing bids or competing plans, any determination that the price was top dollar would necessarily be made by a judge in bankruptcy court, whereas the best way to determine value is exposure to a market.”¹⁴ However, if the debtor desires to retain ownership of the collateral, a true market test through a public auction is not possible. Therefore, out of necessity, judicial valuation of property is a part of the chapter 11 process.

The Bankruptcy Code includes certain provisions designed to protect secured lenders against a judicial undervaluation when the debtor will keep the collateral, either during the chapter 11 case or under a plan of reorganization. For example, section 507(b) gives the secured creditor a “superpriority” administrative expense claim (an administrative expense claim with priority over other administrative expense claims) to the extent that “adequate protection” granted to the creditor and approved by the court eventually falls short and proves to have been inadequate with the benefit of hindsight by the end of the case.¹⁵

Another protection against judicial undervaluation of a secured creditor’s collateral in connection with a plan of reorganization is section 1111(b)(1) of the Bankruptcy Code, which generally permits the holder of a nonrecourse mortgage to assert an unsecured deficiency claim against the estate unless the debtor sells the collateral during the case or under a chapter 11 plan.¹⁶ The unsecured deficiency claim would not exist outside of bankruptcy or in a chapter 7 case because of the nonrecourse

13. See, e.g., Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930 (2006); Keith Sharfman, *Judicial Valuation Behavior: Some Evidence from Bankruptcy*, 32 FLA. ST. U. L. REV. 387 (2005).

14. 526 U.S. 434, 457 (1999).

15. 11 U.S.C. § 507(b) (2010).

16. *Id.* § 1111(b)(1). See 7 COLLIER ON BANKRUPTCY ¶ 1111.03 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

nature of the debt, but is recognized in chapter 11.¹⁷ Although the creditor may be harmed by judicial undervaluation of the collateral, that harm may be mitigated to some extent by giving the creditor a distribution on a fictitious unsecured deficiency claim.

Section 1111(b)(2) goes even further in protecting creditors against undervaluation of their collateral by allowing a class of undersecured creditors to elect to have their claims treated as fully secured claims in certain circumstances.¹⁸ The effect of such an election is that the total amount owed to a secured creditor in that class will not be subject to bifurcation into secured and unsecured deficiency claims under section 506(a). Such protection is not absolute and judicial valuation of collateral may be necessary; but if the debtor retains the collateral under a chapter 11 plan, in order to satisfy the requirements for confirmation under section 1129(b) the secured creditors in a section 1111(b)(2) electing class must receive under the plan deferred cash payments that, in the aggregate, equal at least the amount of the debt regardless of any judicial valuation.¹⁹ Such cash payments must also have a present value of at least the value of the collateral as determined by the court, unless the class votes to accept a plan with a different treatment.²⁰ Thus, although the court values the collateral to determine whether the present value of the deferred cash payments is sufficient, the plan must provide that secured creditors will receive a cash stream that, in the aggregate, equals the full amount of their total claims. For example, if a secured creditor in a class that elects treatment under section 1111(b)(2) has a \$1 million claim secured by collateral that the judge determines is worth only \$200,000, and the plan is confirmed despite the secured creditor's nonacceptance, the plan must provide for deferred cash payments that have a present value of at least \$200,000 but which total at least \$1 million. However, the right to make an election under section 1111(b)(2) does not apply if the secured creditor has recourse against the debtor and the collateral is sold during the case or under a chapter 11 plan.²¹ Thus, the protection against judicial undervaluation in section 1111(b)(2) is designed primarily to protect secured creditors when property is retained by the debtor. When property is sold free and clear of a lien either during the case or under a plan, the secured creditor does not need the

17. See 11 U.S.C. § 502(b)(1) (2010); see also 7 COLLIER ON BANKRUPTCY, *supra* note 16, ¶ 1111.03[1][a][ii][B] ("If section 1111(b)(1) was not included in the Code and the creditor agreed not to assert a deficiency claim against the debtor personally . . . section 502(b)(1) would require the bankruptcy court to enforce the contract . . . and disallow a deficiency claim.").

18. 11 U.S.C. § 1111(b)(2).

19. 11 U.S.C. § 1129(b)(2)(A)(i) (2010).

20. *Id.*

21. *Id.* § 1111(b)(1)(B). The right to make the election also does not apply if the lien is of inconsequential value.

protection of section 1111(b) because it should be protected from undervaluation by an auction process.

Although an auction process should produce an accurate test of the collateral's market value, the Bankruptcy Code does not assume that auctions are always going to provide secured creditors with true market value when collateral is to be sold. In particular, section 363(k) provides an important protection designed to assure that property is not sold by the bankruptcy estate outside of a chapter 11 plan at a price that is below true market value. Section 363(k) provides secured creditors with the right to bid when collateral is sold during the bankruptcy case and, if a secured creditor purchases the property, it may offset its secured claim against the purchase price instead of paying cash, unless the court orders otherwise for cause.²² This right is often referred to as the right to "credit bid."²³ Most significant, the secured creditor may credit bid up to its entire debt amount without being limited to a judicially determined valuation of the collateral.²⁴ For example, if the debt is \$100,000 and the highest cash bidder offers to purchase the collateral for \$60,000, the secured creditor, believing that the collateral is worth more than \$60,000, could submit a higher bid, say \$70,000, without the need to provide any cash, thus assuring that the secured creditor will not have to accept the proceeds received at a faulty or inadequate auction.

Another provision designed to protect a secured creditor against the risk of undervaluation as a result of an inadequate auction is section 1129(b)(2)(A)(ii), which has been construed by the clear weight of authority to give secured creditors the right to credit bid when collateral is sold free and clear of liens under a chapter 11 plan that was not supported by the secured creditor's class.²⁵ However, two recent court of appeals decisions—the Third Circuit's decision in *In re Philadelphia Newspapers, LLC* and the Fifth Circuit's decision in *In re Pacific Lumber Co.*—have undermined this protection by allowing courts to deprive a secured creditor of the right to credit bid at an auction of the collateral in a sale under a chapter 11 plan that the secured creditor's class voted to reject, so long as the court finds that the plan affords the secured creditor the realization of the indubitable equivalent of its secured claim.²⁶ Although one of those decisions, *Philadelphia Newspapers*, recognizes the possibility that a public auction process could give the secured creditor

22. *Id.* § 363(k).

23. *See, e.g.,* Cohen v. KB Mezzanine Fund II, LP (*In re SubMicron Sys. Corp.*), 432 F.3d 448, 459–61 (3d Cir. 2006).

24. *Id.*

25. *See, e.g.,* River Rd. Hotel Partners, LLC v. Amalgamated Bank (*In re River Road Hotel Partners, LLC*), 651 F.3d 642, 647–48 (7th Cir. 2011).

26. *In re Phila. Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010); *Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009).

the indubitable equivalent of its claim despite the denial of the right to credit bid, the other decision, *Pacific Lumber*, went even further by upholding the confirmation of a plan involving the transfer of the collateral free and clear of liens and cash payment to the objecting secured creditor based solely on a judicial valuation of the collateral—thus depriving the secured creditor of any market-test valuation by auction in a situation in which the collateral was transferred and not retained by the debtor.²⁷ The court concluded that the plan afforded the creditor the indubitable equivalent of its secured claim.²⁸

This Article discusses the effects of these recent decisions on the risk of undervaluation of collateral faced by secured creditors when a chapter 11 plan provides for the sale of collateral free and clear of liens and deprives the secured creditor of the right to credit bid at the auction. Part I addresses the right of a secured creditor to credit bid when collateral is sold free and clear of liens during the bankruptcy case but not under a chapter 11 plan. Part II discusses generally the requirements for confirming a plan despite nonacceptance by a class of secured creditors and how such requirements affect the right to credit bid at a sale under a chapter 11 plan. Part III focuses on the recent decisions of the Third and Fifth Circuits that have upheld plan confirmations despite a denial of the right to credit bid. Part IV discusses a contrary decision of the Seventh Circuit upholding the right to credit bid at asset sales under chapter 11 plans, thereby creating a circuit split on these important issues. Part V discusses the ramifications of the recent decisions curtailing the right to credit bid.

I. THE RIGHT TO CREDIT BID AT A SALE UNDER SECTION 363 OF THE BANKRUPTCY CODE

Section 363(b) of the Bankruptcy Code provides that during a bankruptcy case, a trustee or debtor in possession may, after notice and a hearing, use, sell, or lease property of the estate outside the ordinary course of business.²⁹ Section 363(f) provides that, under certain circumstances, such property may be sold to a third party free and clear of liens and other property interests.³⁰ If a secured creditor's collateral is sold free and clear of its lien, the lien attaches to the proceeds of the sale for the benefit of the secured creditor.³¹

27. See *infra* Part III for a discussion of these cases.

28. See *In re Pac. Lumber*, 584 F.3d at 249 (“We conclude that the MRC/Marathon plan . . . did not violate the absolute priority rule, was fair and equitable, satisfies 11 U.S.C. § 1129(b)(2)(A)(iii), and yielded a fair value of the Noteholders’ secured claim.”).

29. 11 U.S.C. § 363(b).

30. *Id.* § 363(f).

31. 3 COLLIER ON BANKRUPTCY, *supra* note 11, ¶ 363.06 (“It has long been recognized that the bankruptcy court has the power to authorize the sale of property free of liens with the liens attaching

In order to protect the secured creditor from a sale process that may not produce the true market value of the collateral, section 363(k) provides:

At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.³²

Granting a secured creditor the right to credit bid when the debtor is seeking to sell the secured creditor's collateral free and clear of liens, thus using an offset of its claim as currency for the purchase price, was not a new concept when the Bankruptcy Code was enacted. Credit bidding was recognized under common law.³³ While the Uniform Commercial Code is silent on a secured creditor's right to credit bid at a foreclosure of the secured creditor's collateral, at least one bankruptcy court has found that a secured creditor's right to credit bid is implicit in the authorization for the secured creditor to buy at a public sale.³⁴ Congress sought to statutorily protect this right by including section 363(k) in the Bankruptcy Code when it was enacted in 1978.³⁵

It is important to note that, as discussed above, the secured creditor's right to credit bid is not limited to a previous valuation under section 506(a) of the Bankruptcy Code.³⁶ Therefore, the secured creditor can credit bid the face amount of its claim, regardless of whether a previous valuation provided the creditor with a claim bifurcated into both secured and unsecured claims. In essence, the secured creditor's bid sets the value of the collateral.³⁷ For example, suppose that a secured creditor gives the debtor a \$10 million full recourse loan, which was secured by the debtor's factory. At the time of the loan, the factory was worth \$6 million. Assume that the lien on the factory was properly

to the proceeds, with or without the consent of the lienholder.”).

32. 11 U.S.C. § 363(k).

33. 3 COLLIER ON BANKRUPTCY, *supra* note 11, ¶ 363.LH[1] (citing *Wright v. Union Cent. Life Ins. Co.*, 304 U.S. 502 (1938); *Van Huffel v. Harkelrode*, 284 U.S. 225 (1931); *Ray v. Norseworthy*, 90 U.S. (23 Wall.) 128 (1874); *Allebach v. Thomas (In re Nicholson)*, 16 F.2d 853 (4th Cir. 1927)).

34. *In re Finova Capital Corp.*, 356 B.R. 609, 624–25 (Bankr. D. Del. 2006) (“Although [the UCC] falls short of granting secured creditors a right to credit bid, it does grant them a right to ‘buy’ without limiting the form of acceptable payment. Given that the [UCC] allows secured creditors to buy and . . . [the UCC does not] prohibit credit bidding, it would be overly-formalistic to prohibit credit bidding in this situation. As the proceeds of a sale under [the UCC] are used to pay the debt owed to the secured creditor, it is ultimately inconsequential whether a secured creditor pays with cash or with the reduction of debt. The end result is the same.”).

35. 124 CONG. REC. S33,995 (daily ed. Oct. 5, 1978) (statement of Sen. DeConcini); 124 CONG. REC. H32,396 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards).

36. *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 460–61 (3d Cir. 2006).

37. *Id.* (stating that one rationale behind the secured creditor's right to credit bid is that “by definition [the bid itself] becomes the value of [the lender's] security interest in [the collateral]”).

perfected and not subject to any infirmity. Subsequently, the debtor files for chapter 11 bankruptcy relief, at which time the principal balance due on the loan is still \$10 million and the factory is worth \$7 million according to a valuation provided by the bankruptcy court. Under section 506(a) of the Bankruptcy Code, the secured creditor has a secured claim for \$7 million and an unsecured deficiency claim for \$3 million. If the debtor seeks to sell the factory during the bankruptcy case under section 363(b), the secured creditor would be protected by its right to credit bid up to the full amount of its claim, or \$10 million, at a sale of the factory. By becoming the winning bidder, the secured creditor would buy the factory and, instead of paying any cash, its claim against the debtor would be reduced by the amount of the credit bid. In this scenario, the secured creditor would own the factory after the sale without the need to pay any cash, and would have an unsecured deficiency claim against the debtor's bankruptcy estate for any difference between the amount of the credit bid and the amount of the debt. If the secured creditor bid the full \$10 million, it would have no deficiency claim. The creditor, as purchaser, would be free to keep the property (hoping for price appreciation) or sell the property for a negotiated amount or by conducting its own auction.

Presumably, a secured creditor will not credit bid unless it believes that all other bidders will bid amounts that are less than the actual market value of the collateral.³⁸ The secured creditor would not want to submit a credit bid above the true value of the collateral because, to the extent that a credit bid exceeds the true value, the secured creditor forfeits an unsecured deficiency claim against the bankruptcy estate.³⁹ If there will be no distribution to unsecured creditors, the loss of a deficiency claim will have no adverse consequence. However, even if a deficiency claim is worthless, the secured creditor ordinarily would not want to bid more than the actual value of the collateral because it would have to incur the costs of maintaining and reselling the collateral after the purchase. Of course, if a third-party bidder believes the secured creditor's credit bid undervalues the collateral, it may bid a higher amount and prevail at the auction, in which case the secured creditor's lien attaches to the proceeds of the sale.⁴⁰ In that regard, the secured creditor may have the advantage of familiarity with the debtor's business and greater information regarding the actual value of the assets.⁴¹ In any

38. *Id.* (stating that one rationale behind credit bidding is that a secured creditor would "not outbid [a] [bidder] unless [the] [lender] believe[d] it could generate a greater return on [the collateral] than the return for [the] [lender] represented by [the] [bidder's] offer").

39. *Id.*

40. *Id.*

41. Vincent S. J. Buccola & Ashley C. Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 GEO. MASON L. REV. 99, 120 (2010) ("As a secured party, the creditor wishing to credit

event, the credit bidder has the distinct advantage in the auction process because it need not use its cash or otherwise seek alternative financing to make the purchase.

Section 363(k) was amended in 1984 to give bankruptcy courts the discretion to preclude a secured creditor from credit bidding “for cause.”⁴² However, because the Bankruptcy Code does not define “cause,” courts have discretion to determine the circumstances that justify denial of such right.⁴³ In general, a court may deny the right to credit bid if such denial is in the interest of furthering a policy advanced by the Bankruptcy Code, such as when credit bidding would chill the bidding process or would otherwise hinder the reorganization process.⁴⁴ In particular, bankruptcy courts have denied the right to credit bid for cause where the court has found that (1) the debtor failed to notify other interested parties (especially other secured creditors) of the asset sale, (2) the sale to the credit bidder would be for an inadequate sale price, (3) there was a bona fide dispute regarding the validity of the secured creditor’s lien, and (4) the sale would be delayed and the value of property would be diminished due to questions regarding the status of a creditor’s lien.⁴⁵ Despite the court’s discretion to deny the right to credit bid under section 363(k), the presumption is that the right applies and the burden to prove cause for the denial of such right is on the debtor or any other party in interest who seeks to prevent the secured creditor from credit bidding.⁴⁶

bid is likely more familiar with the debtor’s business and assets than are other prospective buyers. Through its history of monitoring the debtor, the credit bidder may be privy to information about the true value of the collateral the debtor is selling that is not apparent to other would-be bidders.”).

42. See *In re Phila. Newspapers, LLC*, 599 F.3d 298, 315 (3d Cir. 2010).

43. *Id.* at 315–16.

44. *Id.* at 316 n.14 (“A court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment.” (citing 3 COLLIER ON BANKRUPTCY, *supra* note 11, ¶ 363.09[1])).

45. See, e.g., *In re River Rd. Hotel Partners, LLC*, No. 09 B 30029, 2010 WL 6634603, at *2 (Bankr. N.D. Ill. Oct. 5, 2010) (“[C]ourts have required secured creditors to put cash in escrow, pay a portion of the bid in cash, or furnish a letter of credit when the amount and validity of an alleged senior lien is in dispute.”); *In re Takeout Taxi Holdings, Inc.*, 307 B.R. 525, 534 (Bankr. E.D. Va. 2004) (holding that there was sufficient “cause” to deny credit bidding because four of the secured creditors were not served with the sale motion and two did not receive a copy of the notice of the proposed sale); *In re Theroux*, 169 B.R. 498, 499 (Bankr. D.R.I. 1994) (holding that “cause” exists where the “intended selling price is only a fraction of the fair market value” and “the sale, as proposed, [would] benefit *only* the secured creditor, while inflicting [significant] financial damage upon the taxing authorities”); *In re Diebart Bancroft*, Nos. 92-3744, 92-3745, 1993 U.S. Dist. LEXIS 836, at *15 (E.D. La. Jan. 25, 1993) (regarding cause to deny the right to credit bid, the court held that “there was cause shown: namely, the need for cash in escrow to satisfy the lien dispute”).

46. See *In re Phila. Newspapers*, 599 F.3d at 332–33 n.18.

II. CREDIT BIDDING AT AN ASSET SALE UNDER A CHAPTER 11 PLAN

In contrast to a section 363 asset sale during a bankruptcy case, assets may also be sold under a chapter 11 plan. Section 1123(a)(5) of the Bankruptcy Code requires that every plan provide for adequate means for the plan's implementation, such as, among other possible actions, the "sale of all or any part of the property of the estate, either subject to or free of any lien."⁴⁷ Moreover, section 1123(b), which sets forth optional plan provisions, states that a plan may "provide for the sale of all or substantially all of the property of the estate."⁴⁸

A chapter 11 plan must be confirmed by the court for it to become effective and binding on the parties, and section 1129 of the Bankruptcy Code sets forth the requirements for confirmation.⁴⁹ In most cases, the debtor will seek the acceptance of the plan from all classes of claims and equity interests that are impaired by the plan.⁵⁰ If all impaired classes accept the plan and a number of other requirements listed in section 1129(a) are satisfied, the plan may be confirmed.⁵¹ However, if an impaired class does not accept the plan, it may be confirmed nonetheless, or "crammed down" the rejecting class, if certain requirements specified in section 1129(b) have been met.⁵² Most significantly, a plan may be crammed down a rejecting class only if the plan does not discriminate unfairly and is "fair and equitable" with respect to that class.⁵³ If the rejecting class consists of secured claims, section 1129(b)(2)(A) provides that it would not be fair and equitable, and thus cannot be confirmed, unless the plan provides for at least one of the following alternative treatments of the secured claims in that class: (1) the secured creditors, among other things, retain their liens on the collateral and receive deferred cash payments; (2) the collateral is sold free and clear of the liens, subject to the right to credit bid; or (3) the secured creditors realize the "indubitable equivalent" of their secured claims.⁵⁴ In particular, section 1129(b)(2)(A) provides that the following treatment must be afforded the nonaccepting class of secured claims for the plan to satisfy the fair and equitable requirement:

47. 11 U.S.C. § 1123(a)(5)(D) (2010).

48. *Id.* § 1123(b)(4). The sale of all—or substantially all—of the debtor's assets in a chapter 11 case has become common in recent years. *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675 (2003); *see also* Buccola & Keller, *supra* note 41, at 99 ("In high-stakes cases, bankruptcy judges now serve primarily as auctioneers.").

49. *See* 11 U.S.C. §§ 1129, 1141(a) (2010).

50. *See id.* § 1124 (regarding impairment of claims); *id.* § 1126 (regarding acceptance of a chapter 11 plan).

51. *See id.* § 1129 (regarding the requirements for a chapter 11 plan confirmation); *see also* 7 COLLIER ON BANKRUPTCY, *supra* note 16, ch. 1129.

52. *See* 11 U.S.C. § 1129(b)(1).

53. *Id.* § 1129(b).

54. *Id.* § 1129(b)(2)(A).

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.⁵⁵

Until recently, the majority view among commentators and courts was that if a chapter 11 plan provides for the sale of collateral free and clear of liens, the second alternative as set forth in section 1129(b)(2)(A)(ii) *must* be satisfied, thus affording a nonaccepting secured creditor class the right to credit bid at the sale, rather than providing them with an alternative treatment under section 1129(b)(2)(A)(iii), which is the indubitable equivalent of their secured claims.⁵⁶ That is, a plan calling for the sale of collateral free and clear of liens over the objection of the secured creditor class must provide the same right to credit bid as the creditor would have in a sale under section 363(k) of the Bankruptcy Code. By affording the secured creditor the right to credit bid in a sale under a plan, the creditor is protected against the undervaluation of its collateral resulting from a defective auction that fails to obtain the true market value of the property or from a judicial valuation in lieu of an auction.

III. TWO RECENT DECISIONS DENYING SECURED CREDITORS THE RIGHT TO CREDIT BID AT PLAN SALES

In surprising recent decisions, two courts of appeals have held that a plan that provides for the sale of collateral free and clear of liens may be fair and equitable, and thus may be crammed down a class of secured claims, despite the fact that the plan deprives an objecting secured creditor of the right to credit bid up to the face amount of its claim.⁵⁷ Both appellate courts held that a bankruptcy court may use its discretion to approve a sale of assets pursuant to a cram-down plan, even if the

55. *Id.* § 1129(b)(2)(A)(i)–(iii).

56. *In re Phila. Newspapers, LLC*, 599 F.3d 298, 319 (3d Cir. 2010) (Ambro, J., dissenting).

57. See generally *In re Phila. Newspapers*, 599 F.3d 298; *Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm.* (*In re Pac. Lumber Co.*), 584 F.3d 229 (5th Cir. 2009).

secured creditor has been denied the right to credit bid, if the court determines that the affected secured creditor will realize the indubitable equivalent of its claim under section 1129(b)(2)(A)(iii).⁵⁸ These courts found subsections (i) through (iii) of section 1129(b)(2)(A) to be clear and unambiguous in providing three separate alternatives and, therefore, they did not give significant weight to the policy or legislative history behind the enactment of these and other related sections in the Code.⁵⁹

A. *IN RE PACIFIC LUMBER CO.*

In *Pacific Lumber*, six affiliated entities involved in growing, harvesting, and processing redwood timber in Humboldt County, California, filed separate chapter 11 petitions in the bankruptcy court for the Southern District of Texas in 2007.⁶⁰ The six cases were jointly administered by the bankruptcy court.⁶¹ The principal debtors were Pacific Lumber Company, referred to in the case as “Palco,” and Scotia Pacific LLC, referred to as “Scopac.”⁶² Palco owned and operated a sawmill and a power plant in the town of Scotia, California.⁶³ Palco also owned Scopac, which was a Delaware special purpose entity.⁶⁴ In 1998, Palco transferred ownership of more than 200,000 acres of redwood timberland, referred to in the case as the “Timberlands,” to Scopac to enable Scopac to issue approximately \$867 million in notes secured by the Timberlands and certain other assets owned by Scopac.⁶⁵ The Bank of New York Trust Co., in its capacity as indenture trustee with respect to the notes, represented the noteholders in the bankruptcy case.⁶⁶ When the bankruptcy cases commenced, Scopac owed the noteholders approximately \$740 million in principal and accrued interest on the notes.⁶⁷ Scopac also owed approximately \$36 million to Bank of America on a secured line of credit with a right to payment that was senior in priority to the noteholders.⁶⁸ Marathon Structured Finance held a secured claim against Palco’s assets, which approximated \$160 million,

58. See cases cited *supra* note 57.

59. See cases cited *supra* note 57.

60. 584 F.3d at 236.

61. *Id.*

62. *Id.* at 236 & n.2. The four additional debtors included: (i) Britt Lumber Company, Inc., a manufacturer of fencing and decking products; (ii) Scotia Inn, Inc., operator of the inn in Scotia, California; (iii) Salmon Creek, LLC, a holding company owning roughly 1,300 acres of timberland; and (iv) Scotia Development Corp., LLC, a development corporation for exploring and facilitating development opportunities in commercial, industrial, and residential properties in California and Texas. These four entities and Scopac are all wholly owned by Palco.

63. *Id.* at 236.

64. *Id.*

65. *Id.*

66. *Id.* at 236–37.

67. *Id.* at 237.

68. *Id.*

including amounts relating to financing extended before and after the bankruptcy case commenced.⁶⁹ Marathon estimated that Palco's assets were worth approximately \$110 million on the date of the bankruptcy filings.⁷⁰

Marathon and Mendocino Redwood Company ("MRC"), a competitor of Palco, teamed up and sought to play a significant role in the reorganization of the debtors, including making a major cash investment in the companies.⁷¹ Together, they proposed a chapter 11 plan that provided for the dissolution of all six debtor entities, cancellation of all intercompany debt owed between the debtors, and the creation of two new entities, Townco and Newco.⁷² Substantially all of Palco's assets would be transferred to Townco.⁷³ The Timberlands and the assets of the sawmill would be placed in Newco.⁷⁴ MRC and Marathon proposed to contribute approximately \$580 million to Newco so that the money could be used to pay claims against Scopac.⁷⁵ In addition, Marathon would seek to convert to equity its senior secured claim against Palco's assets, thereby giving Marathon full ownership of Townco, a 15% ownership interest in Newco, and a new promissory note in the amount of the sawmill's working capital.⁷⁶ MRC would own the other 85% of Newco's equity and would manage the reorganized company.⁷⁷

The plan provided that Marathon and MRC would fund the plan with \$580 million and that the noteholders would be paid the value of their collateral in cash and would receive a lien on the proceeds from pending unrelated litigation against the State of California.⁷⁸ The noteholders' claims were bifurcated into a secured claim for the value of the collateral and an unsecured claim for the amount of the unsecured deficiency.⁷⁹ The value of the collateral was determined by the bankruptcy court at a valuation hearing at which it received extensive testimony on valuation.⁸⁰ Based on the testimony, the bankruptcy court valued the Timberlands collateral at "not more than \$510 million" and held that a \$510 million cash payment was the indubitable equivalent of the noteholders' secured claim with respect to the Timberlands collateral.⁸¹

69. *Id.* at 236.

70. *Id.*

71. *Id.* at 237.

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.* at 239.

79. *Id.* at 238. The noteholders did not elect to have the entire amount of their claims treated as secured claims under section 1111(b)(2) of the Bankruptcy Code.

80. *Id.*

81. *Id.*

The bankruptcy court also valued the noteholders' liens on non-Timberlands collateral, after deducting more senior liens, at \$3.6 million.⁸² Accordingly, the plan proposed to pay \$513.6 million to the noteholders in cash in full satisfaction of their secured claims.⁸³ Yet the total amount owed to the noteholders on their secured notes was approximately \$740 million.⁸⁴

The bankruptcy court confirmed the plan despite its rejection by the class of noteholders, finding that the plan was fair and equitable under section 1129(b)(2)(A) with respect to the noteholders' secured claims.⁸⁵ Though the noteholders argued that the plan was not fair and equitable as to them because the reorganization constituted a sale without affording the noteholders the right to credit bid under subsection 1129(b)(2)(A)(ii), the bankruptcy court held that the plan transactions constituted a "transfer" rather than a "sale" of assets, so that subsection 1129(b)(2)(A)(iii), rather than subsection (ii), was applicable.⁸⁶ The noteholders appealed the bankruptcy court's order confirming the plan, making several arguments including that the plan constituted a sale of the Timberlands to Newco and that, under subsection (ii), the noteholders should have been afforded an opportunity to credit bid at the sale of the Timberlands up to \$740 million, which was the face amount of their claims.⁸⁷ The noteholders argued that allowing them to credit bid would demonstrate that the court's valuation of the Timberlands at \$510 million was inaccurate and undervalued.⁸⁸ The noteholders requested a direct appeal to the court of appeals rather than going through the traditional appeal to the district court or bankruptcy appellate panel, and the Fifth Circuit granted the request.⁸⁹ The court of appeals disagreed with the bankruptcy court's finding that the plan transaction did not constitute a "sale" of assets.⁹⁰

MRC, a competitor of Palco, joined with Palco's creditor Marathon to offer cash and convert debt into equity in return for taking over both Palco and Scopac. New entities wholly owned by MRC and Marathon received title to the assets in exchange for this purchase. That the transaction is complex does not fundamentally alter that it involved a "sale" of the Noteholders' collateral.⁹¹

82. *Id.* at 239.

83. *Id.*

84. *Id.* at 237.

85. *Id.* at 238-39.

86. *Id.* at 245.

87. *Id.*

88. *Id.* at 239.

89. See 28 U.S.C. § 158(d) (2010) (regarding appeals of bankruptcy court orders directly to the court of appeals).

90. *In re Pac. Lumber*, 584 F.3d at 245.

91. *Id.*

Since a sale occurred, the appellate court found that subsection 1129(b)(2)(A)(ii) “could have applied.”⁹²

However, the Fifth Circuit rejected the noteholders’ argument that, because the transaction constituted a sale of its collateral, subsection (ii) of section 1129(b)(2)(A) *must* apply so as to give the noteholders the right to credit bid for the Timberlands.⁹³ “This court has subscribed to the obvious proposition that because the three subsections of [section] 1129(b)(2)(A) are joined by the disjunctive ‘or,’ they are alternatives.”⁹⁴ Thus, the court held that subsection (iii) affords a distinct basis for confirming the plan, without a credit-bidding opportunity, so long as the plan offers the noteholders the indubitable equivalent of their secured claims.⁹⁵ The court recognized that subsection (ii), with credit-bid protection, might be imperative in some cases, but not in *Pacific Lumber* because the cash payment to the noteholders offered a distinct basis for finding that the plan offered the noteholders the indubitable equivalent of their secured claims.⁹⁶

Having held that a debtor may cram down a sale plan on a class of secured creditors pursuant to subsection (iii) of section 1129(b)(2)(A), which does not provide the class of secured creditors with the right to credit bid the face amount of their claims, the court then addressed the question of whether the plan provided the noteholders with the indubitable equivalent of their claims.⁹⁷ The court first noted that subsection (iii) is satisfied if, with respect to a class of secured claims, the plan provides “for the realization by such holders of the indubitable equivalent of *such claims*.”⁹⁸ The term “such claims” refers to the noteholders’ allowed secured claims which, by reason of section 506(a), do not exceed the value of the collateral securing their claims.

Recognizing that there are few judicial decisions explaining what treatment constitutes the indubitable equivalent of a secured claim because most cram-down plans satisfy either subsection (i) or (ii) of section 1129(b)(2)(A), the court gave two examples of when subsection (iii) would be satisfied: abandoning collateral to the secured

92. *Id.*

93. *Id.*

94. *Id.* (citing *Heartland Fed. Sav. & Loan Ass’n v. Briscoe Enters., Ltd.*, II (*In re Briscoe Enters., Ltd.*, II), 994 F.2d 1160, 1168 (5th Cir. 1993)). The court also noted that the three alternatives set forth in section 1129(b)(2)(A) are not even exhaustive because the introductory phrase of section 1129(b)(2) states that the “condition that a plan be fair and equitable *includes* the following requirements.” *Id.* (emphasis added). Section 102(3) of the Bankruptcy Code states that the word “includes” is not limiting, so that a plan that complies with one of the three stated alternatives does not assure that the court will find the plan fair and equitable.

95. *Id.* at 246.

96. *Id.*

97. *Id.*

98. 11 U.S.C. § 1129(b)(2)(A)(iii) (2010) (emphasis added).

creditors or granting them a replacement lien on similar collateral.⁹⁹ In contrast, issuing unsecured notes or equity securities to the secured creditors or giving them cash that is less than the amount of their allowed secured claims would fall short of satisfying the "indubitable equivalent" standard,¹⁰⁰ as would offering them a balloon payment for the full amount of their secured claim ten years after plan confirmation, together with interim interest payments but no requirement to protect the collateral.¹⁰¹

The court, after considering these examples, focused on "what is really at stake in secured credit—repayment of principal and the time value of money"—and concluded that "[w]hatever uncertainties exist about indubitable equivalent, paying off secured creditors in cash can hardly be improper if the plan accurately reflected the value of the Noteholders' collateral."¹⁰² But how can the appellate court know that the bankruptcy court accurately valued the collateral if there was no market test by auction at which the noteholders had a right to credit bid? In fact, in *Pacific Lumber* there was no auction at all. Despite its recognition that the Supreme Court in *Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership* "encourages bankruptcy courts to be wary of the shortcomings of judicial valuation proceedings,"¹⁰³ the Fifth Circuit affirmed the bankruptcy court's confirmation order, concluding that the bankruptcy court's judicial determination of the collateral's value, arrived at after an extensive contested hearing at which eight valuation experts had testified, "is not clearly wrong."¹⁰⁴

Most significantly, the Fifth Circuit upheld a cram-down confirmation against a rejecting class of secured creditors by paying them cash that was less than the total amount of the debt owed to them but that was judicially determined to equal the value of their collateral.¹⁰⁵ Because the

99. *In re Pac. Lumber*, 584 F.3d at 246. The court cited *Sandy Ridge Development Corp. v. Louisiana National Bank (In re Sandy Ridge Development Corp.)*, 881 F.2d 1346, 1352 (5th Cir. 1989), holding that a plan that provided for the return of collateral in satisfaction of the secured creditor's claim, which became known as a "dirt for debt" plan, could satisfy the "indubitable equivalent" standard. The court also cited *Brite v. Sun Country Development, Inc. (In re Sun Country Development, Inc.)*, 764 F.2d 406 (5th Cir. 1985), and Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133, 156 (1979).

100. *In re Pac. Lumber*, 584 F.3d at 246.

101. *Id.* The court cited *In re Murel Holding Co.*, 75 F.2d 941, 942 (2d Cir. 1935), where Judge Learned Hand first used the term "indubitable equivalent."

102. *In re Pac. Lumber*, 584 F.3d at 246-47. The Fifth Circuit rejected the noteholders' argument that depriving them of the right to credit bid and purchase the property deprived them of the indubitable equivalent of their secured claims because it resulted in the forfeiture of the possibility of future increases in the collateral's value: "The Bankruptcy Code, however, does not protect a secured creditor's upside potential; it protects the 'allowed secured claim.'" *Id.* at 247.

103. *Id.* at 247 (citing *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 North LaSalle St. P'ship*, 526 U.S. 434 (1999)).

104. *Id.* at 248.

105. *Id.* at 249.

appellate court concluded that the plan involved a “sale” of the collateral, and an election to be treated as fully secured under section 1111(b)(2) is not available to the holders of recourse claims when collateral is sold under a plan,¹⁰⁶ the noteholders would not have had the right to make such an election. Also, the Fifth Circuit held that the noteholders did not have the right to credit bid for their collateral.¹⁰⁷ Therefore, the court held that secured creditors can be deprived of both the right to make a section 1111(b)(2) election and the right to credit bid for its collateral—the two primary protections against undervaluation of collateral—with respect to a cram-down confirmation, as long as the court is satisfied that its judicial valuation would enable the secured creditor to realize the indubitable equivalent of its secured claim.

B. *IN RE PHILADELPHIA NEWSPAPERS, LLC*

In February 2009, Philadelphia Newspapers, LLC, and several affiliates including PMH Holdings, LLC, the parent company of all the debtors, filed chapter 11 bankruptcy petitions in the Eastern District of Pennsylvania.¹⁰⁸ The debtors owned and operated print newspapers, including the *Philadelphia Inquirer*, the *Philadelphia Daily News*, and the online publication *philly.com*, all of which they purchased in 2006 as part of an acquisition of the businesses by a group of mainly Philadelphia-based investors. The investor group formed Philadelphia Media Holdings, LLC (“PMH”), which entered into an asset purchase agreement to buy the print newspapers, the online publication, and the related businesses for a sale price of \$515 million.¹⁰⁹ After the acquisition, the individual who led the investor group assumed the role of the debtors’ chief executive officer and held 6.67% of the equity of the debtors.¹¹⁰ Subsequently, PMH became one of the debtors in the chapter 11 cases.¹¹¹

In order to finance the 2006 acquisition, PMH borrowed approximately \$295 million from a group of lenders, with Citizens Bank of Pennsylvania acting as administrative and collateral agent for the lenders.¹¹² As part of the loan transaction, the lenders were given a security interest in substantially all of the debtors’ assets.¹¹³

106. 11 U.S.C. § 1111(b)(1)(B)(ii) (2010).

107. *In re Pac. Lumber*, 584 F.3d at 245.

108. The cases were jointly administered by the bankruptcy court. See *In re Phila. Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010).

109. *In re Phila. Newspapers, LLC*, 418 B.R. 548, 553 (E.D. Pa. 2009), *aff’d*, 599 F.3d 298 (3d Cir. 2010).

110. *Id.*

111. *In re Phila. Newspapers*, 599 F.3d at 301.

112. *In re Phila. Newspapers*, 418 B.R. at 553.

113. *Id.*

On August 20, 2009, the debtors filed a plan of reorganization that provided for the sale at public auction of substantially all of the debtors' assets free and clear of the lenders' security interest.¹¹⁴ At the same time, the debtors signed an asset purchase agreement with a "stalking-horse" bidder, Philly Papers, LLC.¹¹⁵ The asset purchase agreement, which was subject to bankruptcy court approval, gave Philly Papers the right to buy the assets only if a higher and better offer were not made at the auction.¹¹⁶ Philly Papers is comprised of several equity investors that had a relationship with the debtors, including Carpenters Pension and Annuity Fund of Philadelphia and Vicinity, which held a 30% equity interest in PMH.¹¹⁷ In addition, the person who was chairman and an equity owner of Philly Papers owned approximately 20% of the equity in PMH prior to the bankruptcy case.¹¹⁸

The debtors' chapter 11 plan provided for a cash distribution of approximately \$37 million to the secured lenders, which is the amount that would have been generated from the sale of assets to Philly Papers, assuming that there were no higher and better bids.¹¹⁹ Under the plan, the secured lenders would also receive the debtors' Philadelphia headquarters, valued at \$29.5 million, subject to a two-year rent-free lease for the entity that would operate the newspapers. The total recovery to the secured creditors under the plan was approximately \$66 million in total value, far less than the more than \$300 million that was owed to the lenders at that time.¹²⁰ The secured lenders also would receive any additional cash generated by a higher bid at the public auction.¹²¹

On August 28, 2009, the debtors filed a motion to approve bidding procedures for the public auction, which required that any qualified bidder fund its purchase in cash and expressly precluded the secured lenders from credit bidding for the assets.¹²² In particular, the proposed bidding procedures included the following statement:

The Plan sale is being conducted under section[s] 1123(a) and (b) [and 1129] of the Bankruptcy Code, and not section 363 of the Bankruptcy Code. As such, no holder of a lien on any asset of the Debtors shall be permitted to credit bid pursuant to section 363(k) of the Bankruptcy Code.¹²³

114. *Id.* at 553–54.

115. *In re Phila. Newspapers, LLC*, 599 F.3d 298, 301 (3d Cir. 2010).

116. *Id.* at 302.

117. *In re Phila. Newspapers*, 418 B.R. at 554.

118. *Id.* Penn Matrix Investors, the third entity investor in Philly Papers, LLC, did not have an equity interest in PMH Holdings, LLC, and did not have any prior affiliation with the debtors before the consummation of the asset purchase agreement. *Id.*

119. *In re Phila. Newspapers*, 599 F.3d at 302.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.* (citation omitted).

The secured lenders, as well as the U.S. trustee and other parties, filed objections to the bidding-procedures motion.¹²⁴ The lenders argued that they had a right to credit bid for their collateral.¹²⁵ In response, the debtors argued that denying the secured creditors the right to credit bid would create a more competitive bidding auction.¹²⁶ The debtors asserted that they had engaged in extensive nationwide marketing to ensure that the results of the auction provided the best possible purchase price for the sale of the debtors' assets.¹²⁷ However, the committee of unsecured creditors filed a separate motion challenging that statement and seeking an order directing the debtors to cease a publicity campaign using the mantra "Keep It Local" on the grounds that the campaign was intended to suppress competitive bidding by dissuading out-of-town bidders from purchasing a local Philadelphia newspaper business, thus skewing the auction in favor of Philly Papers.¹²⁸

The bankruptcy court denied the debtors' motion seeking approval of the bidding procedures that would ban the secured lenders from credit bidding at the asset sale.¹²⁹ In denying the motion, the bankruptcy court noted that, until the Fifth Circuit's decision in *Pacific Lumber*, the "clear weight of authority supported the [secured lenders'] position on the issue,"¹³⁰ and that the Fifth Circuit itself acknowledged that "[t]he nature of this cramdown and the refusal to apply [section] 1129(b)(2)(A)(ii) to authorize a credit bid are unusual, perhaps unprecedented decisions."¹³¹

The bankruptcy court agreed with the secured lenders' argument that section 1129(b)(2)(A) should be read in tandem with sections 363(k) and 1111(b) of the Bankruptcy Code.¹³² The bankruptcy court determined that, from a review of the legislative intent regarding sections 363(k), 1111(b), and 1129(b)(2)(A), the sale of the collateral by the debtors

124. *Id.*

125. *In re Phila. Newspapers, LLC*, 418 B.R. 548, 569 (Bankr. E.D. Pa. 2009).

126. *Id.* at 555.

127. *Id.*

128. *Id.* at 555 n.10.

129. *In re Phila. Newspapers, LLC*, No. 09-11204SR, 2009 Bankr. LEXIS 3167, at *26 (Bankr. E.D. Pa. Oct. 8, 2009), *rev'd*, 418 B.R. 548 (E.D. Pa. 2009).

130. *Id.* at *17-18 (citing *In re Matrix Dev. Corp.*, No. 08-32798-tmb11, 2009 Bankr. LEXIS 1972, at *8 (Bankr. D. Or. July 16, 2009); *In re SunCruz Casinos, LLC*, 298 B.R. 833, 839 (Bankr. S.D. Fla. 2003); *In re River Vill. Assocs.*, 181 B.R. 795, 805 (Bankr. E.D. Pa. 1995); *In re Kent Terminal Corp.*, 166 B.R. 555, 566-67 (Bankr. S.D.N.Y. 1994); *In re Orfa Corp. of Phila.*, Nos. 90-11253S, 90-11254S, 90-11255S, 1991 Bankr. LEXIS 1952, at *17-20 (Bankr. E.D. Pa. Oct. 31, 1991); *In re 222 Liberty Assocs.*, 108 B.R. 971, 978 (Bankr. E.D. Pa. 1990); *H & M Parmely Farms v. Farmers Home Admin.*, 127 B.R. 644, 648 (Bankr. D.S.D. 1990); *In re Realty Inv., Ltd. V*, 72 B.R. 143, 146 (Bankr. C.D. Cal. 1987)).

131. *Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229, 243 (5th Cir. 2009); *In re Phila. Newspapers*, 2009 Bankr. LEXIS 3167, at *25.

132. *In re Phila. Newspapers*, 2009 Bankr. LEXIS 3167, at *18-19 ("[T]he *Criimi Mae Court* did not consider the interplay between Code section 363(k), 1111(b) and 1129 [of the Bankruptcy Code]....").

required that the secured creditors have the right to credit bid the face amount of their claims at the auction.¹³³ The bankruptcy court also noted that while the proposed plan proceeded under subsection (iii), the “indubitable equivalent” subsection of section 1129(b)(2)(A), it was structured as a subsection (ii) sale in every respect other than the right to credit bid.¹³⁴

According to the bankruptcy court, if a debtor may satisfy subsection (iii) through a public auction without affording the secured creditor the right to credit bid, it would be illogical for Congress to enact the statute to provide for subsection (ii) as an alternative to subsection (iii).¹³⁵ Effectively, subsection (iii) would render subsection (ii) superfluous.¹³⁶ Accordingly, the bankruptcy court ruled in favor of the secured creditors and denied the debtors’ bidding procedures motion.¹³⁷

The district court reversed the decision of the bankruptcy court, holding that the plain language of section 1129(b)(2)(A) does not provide that secured creditors are entitled to credit bid at a cram-down plan sale.¹³⁸ Similar to the Fifth Circuit’s reasoning in *Pacific Lumber*, the district court focused on the plain language of subsections (i) through (iii) and reasoned that the three routes to plan confirmation under a cram-down plan sale are independent avenues separated by the disjunctive “or,” therefore rendering each prong independently sufficient for confirmation of a plan as “fair and equitable.”¹³⁹ The district court relied on the fact that the right to credit bid was not incorporated into subsection (iii) by Congress and viewed the use of the “indubitable equivalent” standard as an “invitation to debtors to craft an appropriate treatment of a secured creditor’s claim, separate and apart from the provisions of subsection (ii).”¹⁴⁰

The secured creditors appealed the district court decision to the Third Circuit and, pending resolution of the appeal, the court stayed the auction.¹⁴¹ In affirming the district court’s order,¹⁴² the Third Circuit

133. *Id.* at *20–21 (citing 124 CONG. REC. S17420 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini); 124 CONG. REC. HU, 104 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards)).

134. *Id.* at *19–20.

135. *Id.* at *14 (“[T]he Court disagrees with the proposition that, although § 1129(b)(2)(A) specifies three alternative means by way of which a reorganization plan may be confirmed, the last of these three (indubitable equivalence) may be employed when the exact means by which the plan intends the indubitable equivalent cramdown of a dissenting secured creditor is a cash out of the creditor via an auction sale such as is provided for in detail under the second of the three described alternatives.”).

136. *Id.* at *14–15.

137. *Id.* at *30–31.

138. *In re Phila. Newspapers, LLC*, 418 B.R. 548, 552, 567 (Bankr. E.D. Pa. 2009).

139. *Id.* at 567 (“The use of the connector ‘or’ in section 1129(b)(2)(A) supports the conclusion that the three alternatives are to be applied in the disjunctive.”).

140. *Id.* at 568.

141. *In re Phila. Newspapers, LLC*, 599 F.3d 298, 303 (3d Cir. 2010).

found no statutory basis to conclude that subsection (ii) is the sole provision under which a debtor may seek to confirm a cram-down plan sale under section 1129(b)(2)(A) of the Bankruptcy Code, reasoning, as did the district court, that section 1129(b)(2)(A) is phrased in the disjunctive and the use of the word “or” in the statute operates to provide alternative means for a debtor to provide the secured creditor “fair and equitable” treatment.¹⁴³ The Third Circuit found the language of section 1129(b)(2)(A) unambiguous and, based upon the plain meaning of the statute and recent precedent, namely the holding in *Pacific Lumber*, affirmed the decision of the district court and concluded that section 1129(b)(2)(A) provides that a cram-down plan sale can be confirmed as “fair and equitable” under the “indubitable equivalent” standard pursuant to subsection (iii), rather than by providing the secured creditor the right to credit bid under subsection (ii).¹⁴⁴

It is important to emphasize that the Third Circuit did not find that, under the particular facts of the case, a public auction without the right to credit bid will result in the secured lenders receiving the indubitable equivalent of their secured claims. It did not go that far in its holding. Indeed, the court cautioned that “our holding here only precludes a lender from asserting that it has an absolute right to credit bid when its collateral is being sold pursuant to a plan of reorganization”.¹⁴⁵

Both the District Court below and the Fifth Circuit in *Pacific Lumber* contemplated that, in some instances, credit bidding may be required . . . [A] lender can still object to plan confirmation on a variety of bases, including that the absence of a credit bid did not provide it with the “indubitable equivalent” of its collateral.¹⁴⁶

Judge Thomas L. Ambro, in his dissenting opinion, disagreed with the majority’s view that the language of section 1129(b)(2)(A) is unambiguous:

I cannot agree that the plain language of § 1129(b)(2)(A) is unambiguous and compels the sole interpretive conclusion they see as the plain meaning of the words. There is more than one reasonable reading of the statute, and thus we cannot simply look to its text alone in determining what Congress meant in enacting it.¹⁴⁷

142. *Id.* at 304.

143. *Id.* at 305 (“The use of the word ‘or’ in [section 1129(b)(2)(A)] operates to provide alternatives—a debtor may proceed under subsection (i), (ii), or (iii), and need not satisfy more than one subsection.”).

144. *Id.* at 313–14.

145. *Id.* at 317.

146. *Id.* at 317–18.

147. *Id.* at 319 (Ambro, J., dissenting). Disagreement over the plain meaning of section 1129(b)(2)(A) “indicates that the provision is ambiguous when read in isolation and does not have a single plain meaning.” *Id.* at 322. “[B]oth the District Court and the Bankruptcy Court read [section 1129(b)(2)(A)] in a plausible fashion, yet came to the opposite conclusions. Reasonable minds can differ on the interpretation of § 1129(b)(2)(A) as it applies to plan sales free of liens.” *Id.*

Based on his review of established canons of statutory interpretation, the entire Bankruptcy Code, and the Code's legislative history, Judge Ambro concluded that a plan providing for the sale of collateral free and clear of liens may be crammed down a nonaccepting class of secured creditors only if the secured creditors are provided the right to credit bid the face amount of their claims under subsection 1129(b)(2)(A)(ii).¹⁴⁸

Judge Ambro views subsections (i) through (iii) as three distinct ways in which a debtor can seek confirmation of a plan that is rejected by a class of secured creditors, but the application of each subsection depends on how the plan proposes to treat the claims of the secured creditors.¹⁴⁹ That is, subsection (i) applies where secured creditors retain their liens securing their claims, and subsection (ii) applies where the plan provides for a sale free and clear of liens.¹⁵⁰ Last, subsection (iii) can be viewed as a catch-all provision for the protection of secured creditors only when subsections (i) and (ii) are not clearly applicable.¹⁵¹

To arrive at that proper reading of section 1129(b)(2)(A), Judge Ambro wrote that it is necessary to look beyond plain meaning and to analyze that section in conjunction with the Bankruptcy Code as a whole.¹⁵² Three related provisions in the Bankruptcy Code, sections 1123(a)(5)(D), 363(k), and 1111(b), when taken together, "are integrated parts of congressional policy pertaining to secured creditors' rights when their collateral is sold."¹⁵³ In particular, the dissent viewed sections 1129(b)(2)(A)(ii) and 1111(b) as alternative protections for the secured creditor, one to apply at a sale free and clear of liens and the latter to apply when the secured creditor's collateral is retained by the debtor.¹⁵⁴ When these provisions are viewed in conjunction, they are "part of a comprehensive arrangement enacted by Congress to avoid the pitfalls of undervaluation . . . and thereby ensure that the rights of secured creditors are protected while maximizing the value of the collateral to the

¹⁴⁸ *Id.* at 338.

¹⁴⁹ *Id.* at 325 ("Congress did not list the three alternatives as routes to cramdown confirmation that were universally applicable to any plan, but instead as distinct routes that apply specific requirements depending on how a given plan proposes to treat the claims of secured creditors." (footnote omitted)).

¹⁵⁰ *Id.*

¹⁵¹ *Id.* at 326 (citing *CoreStates Bank, N.A. v. United Chem. Techs., Inc.*, 202 B.R. 33, 49-51 (E.D. Pa. 1996)). In *CoreStates Bank, N.A. v. United Chem. Techs., Inc.*, the debtors' plan provided for a combination of reduced collateral and partial immediate payment to be provided to the secured creditors, rather than for the sale of the secured creditor's collateral free and clear of liens. *Id.* at 326 n.13. According to Judge Ambro, in *CoreStates Bank* the debtors' cram-down plan sale could be confirmed under subsection (iii) because the debtors were not seeking to sell the secured creditors' collateral free and clear of liens. *Id.*

¹⁵² *Id.* at 331.

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 334.

estate and minimizing deficiency claims against other unencumbered assets.”¹⁵⁵

Judge Ambro also discussed the consequences of applying subsection (iii) to cram-down plan sales free and clear of liens.¹⁵⁶ If bankruptcy courts allow a debtor to cram down a plan sale on the secured creditor without the right to credit bid, debtors will pursue confirmation under subsection (iii) where it is advantageous to the debtor, even where such a sale does not maximize value for the estate,¹⁵⁷ thus undermining the fundamental policies of the Bankruptcy Code “by skewing the incentives of the debtor to maximize benefits for insiders, not creditors.”¹⁵⁸ Moreover, if a cram-down plan sale can be achieved by a debtor outside of subsection (ii), then a secured creditor’s collateral may be undervalued and the secured creditor may “lose the only undervaluation protection Congress provided and considered in the sale-free-of-liens scenario.”¹⁵⁹

The dissent also noted that secured creditors take into account the protections provided under the Bankruptcy Code, including the right to credit bid, before extending credit to a borrower, and that the majority’s ruling, which is a departure from established expectations of secured lenders, harms this right.¹⁶⁰ Judge Ambro warned that secured creditors, in order to account for the possibility of being denied their right to credit bid, may provide an upward adjustment to their pricing, which will lead to higher interest rates for borrowers or to reduced credit availability.¹⁶¹ The consequences of the Third Circuit’s decision “include upsetting three decades of secured creditors’ expectations, thus increasing the cost of credit.”¹⁶²

Judge Ambro also commented on the particular facts of the case and noted that the only party that would benefit from undervaluation of the collateral at the auction is the purchaser of the assets, ostensibly Philly Papers, the stalking-horse bidder with substantial insider and equity ties to the debtors.¹⁶³ According to Judge Ambro, the stalking-

155. *Id.*

156. *Id.* at 336.

157. *Id.* (“If the debtors here prevail, a direct consequence is that debtors generally would pursue confirmation under clause (ii) only if they somehow concluded that providing a right to credit bid as required by that clause would be more advantageous to them than denying that right.”).

158. *Id.* at 337.

159. *Id.* at 334.

160. *Id.* at 337 (“[S]ecured credit lowers the costs of lending transactions not only by increasing the strength of the lender’s legal right to force the borrower to pay, but also . . . by limiting the borrower’s ability to engage in conduct that lessens the likelihood of repayment.” (alternation in original) (quoting Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 683 (1997))).

161. *Id.*

162. *Id.* at 338.

163. *Id.* at 336.

horse bidder appeared to be attempting to purchase the assets as cheaply as possible—an outcome that is more likely if the lenders are deprived of the right to credit bid at the auction.¹⁶⁴ Though the lenders could submit a cash bid at the auction, which essentially would be writing a check to themselves, Judge Ambro pointed out that there are coordination difficulties involved in a large syndicated loan that could present obstacles to multiple lenders making an effective cash bid.¹⁶⁵

As did the majority, Judge Ambro emphasized that the Third Circuit's decision did not finally determine whether the lenders are receiving fair and equitable treatment under the proposed chapter 11 plan:

In any event, I do not take the majority opinion to preclude the Bankruptcy Court from finding, as a factual matter, that the debtors' plan is a thinly veiled way for insiders to retain control of an insolvent company minus the debt burden the insiders incurred in the first place. Nor do I take the majority opinion to preclude the Bankruptcy Court from concluding, at the confirmation hearing, that the plan (and resulting proposed sale of assets free of liens and without credit bidding) does not meet the overarching "fair and equitable" requirement.¹⁶⁶

IV. A CIRCUIT SPLIT: THE SEVENTH CIRCUIT REJECTS *PHILADELPHIA NEWSPAPERS* AND PROTECTS THE RIGHT TO CREDIT BID AT PLAN SALES

The momentum of the recent trend in courts of appeals toward denying secured creditors the right to credit bid at chapter 11 plan sales upon a finding that the sale otherwise provides the secured creditor with the indubitable equivalent of its secured claim was abruptly halted when the Seventh Circuit rejected the reasoning of *Philadelphia Newspapers* in *River Road Hotel Partners, LLC v. Amalgamated Bank*.¹⁶⁷

River Road Hotel Partners, LLC, and certain related entities filed chapter 11 petitions in the Bankruptcy Court for the Northern District of Illinois in 2009.¹⁶⁸ In 2007 and 2008, the River Road entities built the InterContinental Chicago O'Hare Hotel, which opened in 2008.¹⁶⁹ In order to construct the hotel, the River Road entities obtained from certain lenders construction loans of approximately \$155.5 million secured by a mortgage on the hotel property.¹⁷⁰ The loan documents designated Amalgamated Bank as the administrative agent and trustee for those lenders.¹⁷¹ Several months after the opening of the hotel, and

¹⁶⁴ *Id.*

¹⁶⁵ *Id.* at 337.

¹⁶⁶ *Id.* at 338 n.22.

¹⁶⁷ Nos. 10-3597, 10-3598, 2011 U.S. App. LEXIS 13131, at *19 (7th Cir. June 28, 2011).

¹⁶⁸ *Id.* at *5.

¹⁶⁹ *Id.* at *2.

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

after defaulting on certain interest payments on the loans,¹⁷² the River Road entities requested additional funding from the same lenders so that they could complete construction of the restaurant located in the hotel and make certain payments to general contractors and suppliers.¹⁷³ When the parties could not agree on the terms and conditions of the additional funding, the River Road debtors filed chapter 11 petitions.¹⁷⁴ As of the petition date, the River Road debtors owed at least \$140 million on the construction loans.¹⁷⁵

In a separate matter, RadLAX Gateway Hotel, LLC, and certain of its related entities filed chapter 11 petitions in the Bankruptcy Court for the Northern District of Illinois on the same day that the River Road debtors filed their petitions.¹⁷⁶ In 2007, RadLAX purchased the Radisson Hotel at Los Angeles International Airport.¹⁷⁷ In order to purchase the Radisson, make certain renovations, and construct a parking structure, the RadLAX entities obtained a construction loan in the approximate amount of \$142 million from certain lenders.¹⁷⁸ Amalgamated Bank served as administrative agent and trustee for the lenders, which held a mortgage on the hotel property.¹⁷⁹ Prior to the completion of the construction for the parking structure, the RadLAX entities ran out of funding for the project due to unexpected costs and were forced to cease construction.¹⁸⁰ Despite negotiations, the parties could not agree on terms and conditions for additional funding, resulting in the filing of chapter 11 petitions by the RadLAX debtors.¹⁸¹ As of the petition date, the RadLAX debtors owed at least \$120 million on the loans.¹⁸²

In June 2010, the River Road debtors and the RadLAX debtors filed their respective plans of reorganization, each plan providing for the sale at public auction of substantially all of the debtors' assets free and clear of the respective lenders' security interests, with the sale proceeds to be distributed among creditors in accordance with their priorities under the Bankruptcy Code.¹⁸³ The debtors in both cases also filed

172. *Id.* at *2-3 n.2.

173. *Id.*

174. *Id.* at *3.

175. *Id.*

176. *Id.* at *5.

177. *Id.* at *3-4.

178. *Id.* at *4.

179. *Id.*

180. *Id.*

181. *Id.* The cases of the RadLAX debtors were jointly administered by the bankruptcy court. *Id.* at *5.

182. *Id.*

183. See River Rd. Hotel Partners, LLC's and River Rd. Expansion Partners, LLC's Joint Chapter 11 Plan, *In re* River Hotel Partners, LLC, No. 09-B-30029 (Bankr. N.D. Ill. June 4, 2010); Debtors' Joint Chapter 11 Plan, *In re* RadLAX Gateway Hotel, LLC, No. 09-30047 (Bankr. N.D. Ill. June 4, 2010).

substantially similar motions to approve bidding procedures for the asset sales, which required that any qualified bidder fund its purchase in cash and expressly precluded the secured lenders from credit bidding for the assets.¹⁸⁴ In particular, both proposed bidding procedures included the following statement:

The Plan sale is being conducted under sections 1123(a) and (b) and 1129(b)(2)(A)(iii) of the Bankruptcy Code, and not section 363 of the Bankruptcy Code. As such, no holder of a lien on any assets of the Debtors shall be permitted to credit bid pursuant to section 363(k) of the Bankruptcy Code.¹⁸⁵

The debtors' proposed bidding procedures, which were subject to court approval, also provided for the sale of the assets to the highest bidder.¹⁸⁶ The initial bid in each case would be supplied by a stalking-horse bidder arranged during the chapter 11 cases.¹⁸⁷ The River Road stalking-horse bid was in the approximate amount of \$42 million and the RadLAX stalking-horse bid was in the approximate amount of \$47.5 million.¹⁸⁸

Amalgamated Bank, on behalf of the lenders, filed objections to the proposed bidding procedures.¹⁸⁹ The bank argued that the secured lenders had not accepted the chapter 11 plans and, therefore, that the plans could not be confirmed because they provided for the sale of the lenders' collateral free and clear of liens without providing the lenders with the right to credit bid their claims as required by subsection (ii) of section 1129(b)(2)(A) of the Bankruptcy Code.¹⁹⁰ In response, the debtors argued that the plans were "fair and equitable" because, though the lenders were not provided the right to credit bid their claims under the proposed bidding procedures, the lenders would receive the indubitable equivalent of their claims under subsection (iii).¹⁹¹

184. See Debtors' Motion for an Order: (A) Approving Procedures for the Sale of Substantially All of the Debtors' Assets; (B) Scheduling an Auction; (C) Approving Assumption and Assignment Procedures; (D) Approving Form of Notice; and (E) Granting Related Relief at 21, *In re River Rd. Hotel Partners, LLC*, No. 09-B-30029 (Bankr. N.D. Ill. June 4, 2010); Debtors' Motion for an Order: (A) Approving Procedures for the Sale of Substantially all of the Debtors' Assets; (B) Scheduling an Auction; (C) Approving Assumption and Assignment Procedures; (D) Approving Form of Notice; and (E) Granting Related Relief at 21, *In re RadLAX Gateway Hotel, LLC*, No. 09-30047 (Bankr. N.D. Ill. June 4, 2010).

185. Debtors' Motion for an Order, *In re River Rd. Hotel Partners*, *supra* note 184, at 16; Debtors' Motion for an Order, *In re RadLAX Gateway Hotel*, *supra* note 184, at 15.

186. See Debtors' Motion for an Order, *In re River Rd. Hotel Partners*, *supra* note 184, at 12; Debtors' Motion for an Order, *In re RadLAX Gateway Hotel*, *supra* note 184, at 10.

187. See Debtors' Motion for an Order, *In re River Rd. Hotel Partners*, *supra* note 184, at 9; Debtors' Motion for an Order, *In re RadLAX Gateway Hotel*, *supra* note 184, at 7.

188. *River Rd. Hotel Partners, LLC v. Amalgamated Bank (In re River Road Hotel Partners, LLC)*, 651 F.3d 642, 645 (7th Cir. 2011).

189. *Id.*

190. *Id.*

191. *Id.* In the alternative, the debtors argued that "cause" existed under sections 1129(b)(2)(A)(ii)

The bankruptcy court denied the debtors' respective motions seeking approval of the bidding procedures, finding that the chapter 11 plans could not be confirmed as "fair and equitable" because they sought to sell the lenders' assets free and clear of liens under subsection (iii), rather than under subsection (ii).¹⁹² The bankruptcy court held that the sale of the lenders' assets free and clear of liens under a cram-down plan sale must comply with subsection (ii), thereby providing the lenders with the right to credit bid their claims at the asset sales.¹⁹³ In reaching its decision, the bankruptcy court found "Judge Ambro's well reasoned dissent in *Philadelphia Newspapers* . . . persuasive."¹⁹⁴

Upon the debtors' motion, the bankruptcy court, noting that the issue was "a matter of public importance," certified the decision for direct appeal to the Court of Appeals in the *River Road* and *RadLAX* bankruptcy cases.¹⁹⁵ In its certification, the bankruptcy judge wrote,

Under current economic conditions a large portion of chapter 11 cases involving commercial real property progress to a sale of assets rather than to reorganization, and many of those sales involve lenders who are owed more than the property is worth. Whether such lenders can credit bid is crucial to the outcome of the sales.¹⁹⁶

The Seventh Circuit consolidated the *River Road* and *RadLAX* direct appeals, affirmed the bankruptcy court's order, and held that cram-down plan sales for encumbered assets free and clear of liens at an auction must satisfy the requirements set forth in subsection 1129(b)(2)(A)(ii) of the Bankruptcy Code, rather than subsection (iii), affording secured creditors the right to credit bid at plan sales.¹⁹⁷ In considering the prior decisions of the Third and Fifth Circuits, the Seventh Circuit commented, "Given that the Debtors' assets in this case have not gone through the judicial valuation process and the Debtors' reorganization plans involve using an auction to determine the assets' current value, it is clear that

and 363(k) to deny the lenders the right to credit bid because, among other things, the credit bids would chill the bidding process. The court held an evidentiary hearing in connection with the debtors' argument and found that the debtors had failed to provide any specific evidence showing that the lenders' credit bids would chill the bidding process. *See id.* at 644.

192. *See id.*

193. *See id.*

194. *See* Bankruptcy Court Order Denying Debtors' Bid Procedures Motion, *In re River Rd. Hotel Partners, LLC* (Bankr. N.D. Ill. Aug. 17, 2010) (No. 09-B-30029), 2010 WL 6634603 at *3.

195. *See* Certification for Direct Appeal to Court of Appeals for the Seventh Circuit at 2, *In re River Rd. Hotel Partners, LLC* (Bankr. N.D. Ill. Aug. 17, 2010) (No. 09-B-30029); *see also* 28 U.S.C. §158(d) (2010) (providing for direct appeals to the applicable court of appeals).

196. *See* Certification for Direct Appeal to Court of Appeals for the Seventh Circuit at 2-3, *In re River Rd. Hotel Partners, LLC* (Bankr. N.D. Ill. Nov. 4, 2010) (No. 09-B-30029).

197. *In re River Rd. Hotel Partners*, 651 F.3d at 645, 653. Prior to its review of the substantive appeals, the Seventh Circuit denied the lenders' argument that the issues raised in the debtors' appeals were moot. *Id.* at 645-47.

Philadelphia Newspapers is more relevant precedent than *Pacific Lumber*.¹⁹⁸

As did Judge Ambro in his dissent in *Philadelphia Newspapers*, the Seventh Circuit found that section 1129(b)(2)(A) is not unambiguous and that there are two plausible interpretations on the question of “whether Subsection (iii) can be used to confirm any type of plan or if it can only be used to confirm plans that propose disposing of assets in ways that can be distinguished from those covered by Subsections (i) and (ii).”¹⁹⁹

The Seventh Circuit also noted that a secured creditor, without the opportunity to credit bid, will not necessarily receive the indubitable equivalent of its claims pursuant to a cram-down plan sale that provides the secured creditor with the proceeds from the sale.²⁰⁰ “Nothing in the text of Section 1129(b)(2)(A) indicates that plans that *might* provide secured lenders with the indubitable equivalent of their claims can be confirmed under Subsection (iii).”²⁰¹ The Seventh Circuit further stated that an auction that prohibits credit bidding might not provide the indubitable equivalent of the secured claim because such a plan sale would not provide a “crucial check against undervaluation.”²⁰² The court listed a number of factors that create substantial risk that assets sold at such a bankruptcy auction will be undervalued: (1) the speed and timing of a bankruptcy auction, (2) the inability to provide sufficient notice to interested parties, (3) an inherent risk of self-dealing on the part of existing management, (4) the current state of limited liquidity likely to keep potential bidders on the sidelines, and (5) the cost of putting together a bid, which is taken into consideration when setting the amount of a bid.²⁰³

Applying canons of statutory interpretation, the Seventh Circuit found that a cram-down plan providing for an asset sale can be confirmed as fair and equitable only under subsection 1129(b)(2)(A)(ii), rather than under subsection (iii).²⁰⁴ Otherwise, subsection (iii) would render subsection (ii) superfluous.²⁰⁵ The Seventh Circuit found that cram-down plan sales can only qualify as “fair and equitable” under subsection (iii) if such plans provide for the disposition of assets in ways that are not already included in subsections (i) and (ii).²⁰⁶ To support its finding, the court cited legislative history indicating that Congressional

198. *Id.* at 649 n.4.

199. *Id.* at 648–50.

200. *Id.*

201. *Id.* at 651.

202. *Id.*

203. *Id.* at 651 n.6.

204. *Id.* at 652.

205. *Id.*

206. *Id.*

intent in drafting section 1129(b)(2)(A) was to provide three distinct avenues to provide “fair and equitable” treatment pursuant to subsections (i) through (iii).²⁰⁷

Following the reasoning of Judge Ambro’s dissent in *Philadelphia Newspapers*, the Seventh Circuit also found that depriving secured creditors of the right to credit bid at plan sales would conflict with other protections provided by the Bankruptcy Code for the benefit of the secured creditor.²⁰⁸ Namely, the protections provided pursuant to sections 363(k) and 1111(b) of the Bankruptcy Code, when viewed together, protect the secured creditor where the debtor either seeks to sell the asset that secures the secured creditor’s debt free and clear of its lien or to retain possession of the encumbered asset.²⁰⁹ Consequently, the court held that cram-down plans that contemplate selling encumbered assets free and clear of liens at an auction must satisfy the requirements set forth in section 1129(b)(2)(ii) of the Bankruptcy Code, which includes an opportunity to credit bid.²¹⁰

The RadLAX debtors filed a petition for certiorari, which was granted by the Supreme Court.²¹¹

V. POTENTIAL CONSEQUENCES OF *PACIFIC LUMBER* AND *PHILADELPHIA NEWSPAPERS*

It is too early to know all of the effects of the decisions of the courts of appeals in *Pacific Lumber* and *Philadelphia Newspapers*, although changes in practice have been observed already. The importance and effects of those decisions, which can deprive secured creditors of the right to credit bid at asset sales under a chapter 11 plan, will depend on whether the Supreme Court adopts the reasoning of these decisions and, if so, on how secured creditors alter their behavior.

A. WILL THE SUPREME COURT ADOPT THE REASONING OF *PACIFIC LUMBER* AND *PHILADELPHIA NEWSPAPERS*?

As emphasized by Judge Ambro in his dissent in *Philadelphia Newspapers*, the overwhelming majority of courts that have considered the issue during the past three decades have held that the right to credit bid at asset sales under a chapter 11 plan must be assured in order to cram down a plan against a class of secured creditors. Indeed, the Seventh Circuit has adopted that view in *River Road*.²¹² It remains to be seen, however, whether the Supreme Court will adopt the views of the

207. *Id.* at 652 n.8.

208. *Id.* at 652–63.

209. *Id.*

210. *Id.* at 653.

211. *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, No. 11-166 (U.S. Dec. 12, 2011).

212. *In re River Rd. Hotel Partners*, 651 F.3d at 653.

Third and Fifth Circuits in departing from that entrenched view. In any event, until the Court resolves the issue, there will be attempts in other circuits to obtain court approval of bidding procedures in connection with the sale of assets under a plan that deprives secured creditors of the right to credit bid. Of course, unless and until the Supreme Court resolves the circuit split, it is likely that debtors planning to resort to chapter 11 to effectuate a sale of assets without affording secured creditors the right to credit bid will engage in forum shopping.²¹³

B. PLAN SALES INSTEAD OF SECTION 363 SALES

Pacific Lumber and *Philadelphia Newspapers* should not affect sales of assets under section 363(b) effectuated before a chapter 11 plan is confirmed. Courts have not held that providing a secured creditor with the indubitable equivalent of its secured claim constitutes “cause” for depriving a secured creditor of the right to credit bid under section 363(k). In contrast, in the Third and Fifth Circuits, the indubitable equivalent is a substitute for the right to credit bid only upon the transfer of collateral free and clear of the secured creditor’s lien under the terms of a chapter 11 plan.²¹⁴ Therefore, debtors desiring to sell assets without credit bidding may wait to effectuate the sale under a plan, rather than under section 363(b) prior to plan confirmation. However, section 363 sales are generally more expedient and can be achieved early in a chapter 11 case. Thus, in the Third and Fifth Circuits, as well as other jurisdictions that follow the views of those circuits, in addition to weighing both the advantages and disadvantages of avoiding credit bidding in the particular circumstances, debtors will need to weigh the benefits of expediency that section 363 provides in contrast to a prolonged plan confirmation and sale process. This is especially true where the collateral is a rapidly wasting asset that needs to be sold quickly to achieve maximum value.

C. ROUND-TRIPPING CASH BIDS FOR ASSETS SOLD UNDER A PLAN

The denial of the right to credit bid at an auction for property free and clear of liens does not deprive a secured creditor of the right to make a cash bid at the auction. If the secured creditor is the highest bidder, it will purchase its own collateral for cash with its lien attaching to the proceeds.²¹⁵ As a practical matter, the secured creditor would be paying

213. See 28 U.S.C. § 1408 (2010) (stating the requirements for venue in bankruptcy cases).

214. *In re Phila. Newspapers, LLC*, 559 F.3d at 298, 310 (3d Cir. 2010); *Bank of N.Y. Trust Co. v. Official Unsecured Creditors’ Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229, 246 (5th Cir. 2009); see also *supra* note 102.

215. In fact, the secured lenders group in *Philadelphia Newspapers*, after losing the appeal in the Third Circuit, submitted the highest and best bid at the auction and purchased the property with a \$105 million cash bid. See Sophia Pearson et al., *Philadelphia Inquirer Lenders Win Bankruptcy Auction with \$139 Million Bid*, BLOOMBERG (Apr. 29, 2010, 9:01 PM), <http://www.bloomberg.com/news/>

cash only to receive it back. Though a chapter 11 plan can provide for payment to the secured creditor over time, in such an event the secured creditor would be entitled to interest on such payments to compensate it for the time value of money.²¹⁶ Thus, credit bidding and cash bidding eventually should have substantially the same economic effect to secured creditors.

For example, if collateral securing a \$15 million claim is to be sold free and clear of liens under a chapter 11 plan and the universe of bidders is willing to bid no more than \$10 million for the collateral, but the secured creditor makes a cash bid of \$11 million, the secured creditor will receive the collateral and will have a security interest in the \$11 million cash proceeds of the collateral. The cash proceeds either will be paid to the secured creditor or will be otherwise returned in some form that will protect the \$11 million interest so that the creditor will realize the indubitable equivalent of its secured claim. In essence, the secured creditor will be recycling the cash—paying it to the debtor only for it to be paid back to the secured creditor. Viewed in this manner, at first glance the deprivation of the right to credit bid may not seem to be a substantial economic loss.

If the secured creditor is a single bank or hedge fund or a small group of lenders, a cash bid may be feasible. However, in today's modern financing environment, it is common for lenders to consist of a syndicate of banks represented by an agent, holders of debt securities in a securitization vehicle represented by a trustee or loan servicer, or some other structure with multiple claim holders participating in the credit facility. In such cases, a collective action by the "lender" may require a vote of the holders of claims and, in any case, there may be no mechanism to compel holders to contribute the cash necessary to make a cash bid. The lack of a way to compel multiple owners of the secured debt under sophisticated lending vehicles to make a further investment of cash could be an obstacle to making a cash bid.

In addition, if the lender does not have sufficient liquidity to make a cash bid or needs to incur short-term borrowing costs or sacrifice short-term opportunity costs with regard to other potential uses of that money, the need to make a cash bid instead of a credit bid could prove costly for the lender. Moreover, if the bankruptcy court finds that a judicial valuation of the collateral in lieu of credit bidding satisfies the "indubitable equivalent" standard of section 1129(b)(2)(B)(iii), as did the court in *Pacific Lumber*, there will be no auction at which a cash bid could be made. Therefore, depriving secured creditors of the right to credit bid

2010-04-28/philadelphia-inquirer-lenders-group-wins-bankruptcy-auction-over-perelman.html.

216. See 11 U.S.C. § 1129(b)(2)(A)(i) (2010).

may, as a practical matter, deprive them of any kind of bidding or may increase the costs of making a bid.

D. BARGAINING FOR THE RIGHT TO CREDIT BID AS A CONDITION TO PROVIDING DEBTOR-IN-POSSESSION FINANCING OR CONSENTING TO THE USE OF CASH COLLATERAL

Prebankruptcy secured lenders willing to provide debtor-in-possession ("DIP") financing to provide liquidity to a company in chapter 11 often have significant bargaining power in negotiating the terms of the financing agreement.²¹⁷ It is not surprising, therefore, that such lenders usually negotiate for a certain amount of control over the bankruptcy case.²¹⁸ For example, DIP lenders often demand that the DIP financing agreement, as well as the court order approving it, provide that the loan may be accelerated in the event that the debtor does not file a plan, or that the court fails to confirm a plan, within a certain time period, unless the lender consents to an extension of time.²¹⁹ Filing a plan that does not have the secured lender's approval may also constitute an event of default by the debtor so as to result in the acceleration of the loan agreement.²²⁰ It is not surprising, therefore, that following *Pacific Lumber* and *Philadelphia Newspapers*, secured lenders have demanded that, as a condition to providing DIP financing, their loan agreements expressly provide that in the event of a sale of the collateral the secured lender shall have the right to credit bid.²²¹ Alternatively, the loan agreement could provide that the filing of any plan by the debtor that provides for the sale of the collateral without affording the lender the right to credit bid shall be an event of default that accelerates the DIP financing.

When a trustee or debtor in possession wants to use cash collateral during the bankruptcy case, either consent of the secured creditor with an interest in the cash collateral must be obtained or the court must permit such use based on the secured creditor's adequate protection.²²² As a condition to providing such consent, secured lenders recently have insisted on a court order providing that the secured lender shall have the right to credit bid in the event of a sale of the collateral under a chapter 11

217. See *id.* § 364 on obtaining credit.

218. CHRISTOPHER W. FROST, CORPORATE GOVERNANCE IN INSOLVENCY AND BANKRUPTCY: A COLLIER MONOGRAPH § 5 [2][a] (Alan N. Resnick & Henry J. Sommer eds., 2011).

219. *Id.*

220. See FED. R. BANKR. P. 4001(c)(1)(B)(vi), which recognizes that financing agreements may establish deadlines for filing a plan of reorganization, for approval of a disclosure statement, for a hearing on confirmation of a plan, or for entry of a confirmation order.

221. See, e.g., *In re Loehmann's Holdings, Inc.*, Nos. 10-16077-10-16081, slip op. at 22 (Bankr. S.D.N.Y. Nov. 15, 2010); *In re Blockbuster Inc.*, Nos. 10-14997, slip op. at 47 (Bankr. S.D.N.Y. Sept. 23, 2010).

222. 11 U.S.C. § 363(c)(2), (e) (2010). For a definition of "cash collateral," see *id.* § 363(a).

plan.²²³ For example, in *In re Magic Brands, LLC*,²²⁴ the order authorizing the debtor in possession to obtain postpetition financing and to use of cash collateral provided:

The Prepetition Agent (on behalf of the Prepetition Secured Parties) shall have the right to “credit bid” the amount of the Prepetition Secured Parties’ claims as of the date of such bid during any sale of all or substantially all of the Debtor’s assets, including without limitation, sales occurring pursuant to section 363 of the Bankruptcy Code or included as part of any restructuring plan subject to confirmation under section 1129(b)(2)(A)(iii) of the Bankruptcy Code.²²⁵

The practice of demanding the right to credit bid as a condition to financing or to consent for the use of cash collateral will undoubtedly grow and such provisions are likely to become boilerplate language in any such agreement. However, if a secured creditor is not willing, or even asked, to provide postpetition financing to the debtor or to consent to the use of its cash collateral, courts following *Pacific Lumber* or *Philadelphia Newspapers* may allow plan proponents effectively to deprive secured creditors of the right to credit bid.

E. INCREASING LITIGATION ON THE APPLICATION OF THE “INDUBITABLE EQUIVALENT” STANDARD AND ITS IMPACT ON THE BIDDING PROCESS

Before 2009, when the right to credit bid at asset sales under a chapter 11 plan was virtually assured, bidders assumed the risk that a secured creditor might outbid them. Nonetheless, potential bidders were willing to compete with the secured creditor on those terms. Though litigation occasionally ensued over the bidding process, there were fewer disputes to resolve because the highest and best offer would win the day. However, since *Pacific Lumber* and *Philadelphia Newspapers*, if a proposed sale of collateral under a chapter 11 plan does not have the secured creditor’s support, and the court substitutes a judicial valuation for the right to credit bid at an auction or approves bidding procedures that require all bidders, including secured creditors, to make cash bids, the court must determine that the judicial valuation or the sales price received would give the secured creditor, in fact and as a matter of law, the indubitable equivalent of the creditor’s secured claim.²²⁶ In the case of an auction, the court would have to be satisfied that the auction process was fair and reasonable in its quest to find the highest and best offer. For that reason, bidders engaging in such auctions may anticipate uncertainty

223. See, e.g., *In re Blockbuster Inc.*, No. 10-14997, slip op. at 7 (Bankr. S.D.N.Y. Oct. 27, 2010); *In re ClearPoint Bus. Res., Inc.*, No. 10-12037, slip op. at 7 (Bankr. D. Del. July 14, 2010); *In re Magic Brands, LLC*, No. 10-11310, slip op. at 21 (Bankr. D. Del. May 17, 2010).

224. No. 10-11310, slip op. at 21.

225. *Id.*

226. 11 U.S.C. § 1129(b)(2)(A)(iii) (2010).

and delay resulting from litigation initiated by secured creditors on the question of whether the auction process actually produced the indubitable equivalent of the secured creditors' claim. It is possible that the greater uncertainty regarding the indubitable equivalent issue and the likelihood that the parties will litigate over these issues will result in fewer parties willing to spend the time and expense necessary to productively engage in the auction process. Thus, the uncertainty and litigation environment that these decisions will cause in jurisdictions following *Pacific Lumber* and *Philadelphia Newspapers* could have a chilling effect on bidding at auction sales.

In contrast, it is possible that the elimination of credit bidding may induce more people to engage in the bidding process because they will no longer have the risk that the secured creditor will obtain the asset merely by providing a higher credit bid. Secured creditors may no longer have the advantage of being able to credit bid the amount of their debt without having to use additional currency. Therefore, with respect to the willingness of potential purchasers and investors to participate in the auction process, it remains to be seen whether the discouraging risk of litigation, delay, and uncertainty regarding the application of the indubitable equivalent issue will be outweighed by the encouraging absence of competition from credit-bidding secured creditors. However, even if the absence of credit bidding would encourage others to participate in the auction process, it would not necessarily result in a price equal to, or exceeding, the price that would be paid if the auction procedures were to allow credit bidding.²²⁷

F. INCREASING THE COST OR REDUCING THE AVAILABILITY OF SECURED CREDIT

In his dissenting opinion in *Philadelphia Newspapers*, Judge Ambro warned that the consequences of depriving secured creditors of the right to credit bid at sales under chapter 11 plans "forces future secured creditors to adjust their pricing accordingly, potentially raising interest rates or reducing credit availability to account for the possibility of a sale without credit bidding."²²⁸ Though Judge Ambro's warning is a reasonable prediction, forecasting the future behavior of lenders is an uncertain endeavor and it remains to be seen whether the loss of credit bidding in plan sales, in and of itself, will have such an effect.

227. When rejecting the notion that allowing credit bidding chills others from cash bidding, Judge Ambro stated that "credit bidding chills cash bidding no more than a deep-pocketed cash bidder would chill less-well-capitalized cash bidders." *In re Phila. Newspapers, LLC* 599 F.3d 298, 321 (3d Cir. 2010).

228. *Id.* at 337. Judge Ambro also wrote that the consequences of denying the right to credit bid "include upsetting three decades of secured creditors' expectations, thus increasing the cost of credit." *Id.* at 338.

If bankruptcy courts in the Third and Fifth Circuits, or in other jurisdictions adopting the views of those circuits, strictly apply a high “indubitable equivalent” standard—which must be met if an objecting class of secured creditors is to be deprived of the right to credit bid—it is possible that courts will allow plans that deny the right to credit bid only in a small minority of cases. This is especially so in the Third Circuit, where the appeals court left the door open in *Philadelphia Newspapers* to a subsequent finding by the bankruptcy court on remand that the secured lenders would not be adequately protected under the particular facts of the case without credit bidding.²²⁹ In addition, opportunities for some secured creditors to negotiate for credit bidding rights as part of DIP financing or cash collateral arrangements, and the opportunity for some other lenders to make round-tripping cash bids, collectively may provide sufficient protection for secured lenders generally so that any increased litigation costs and losses to secured creditors caused by undervaluation of collateral—either by faulty judicial valuations or inadequate auction procedures—might not have a substantial effect, or any effect, on interest rates or the availability of secured credit. In any event, it is too soon to speculate on the impact the decisions of the Third and Fifth Circuits will have on interest rates and the availability of credit if the Supreme Court adopts the views of those courts.

It is also possible that *Pacific Lumber* and *Philadelphia Newspapers* may have some effect on the prices paid for secured claims in the secondary market, especially for private equity investors purchasing secured claims at huge discounts with the expectation of credit bidding for substantially all assets of the company. It is doubtful, however, that the mere possibility of the loss of the right to credit bid in connection with a plan sale will deter distressed investors from engaging in the business of claims trading.

CONCLUSION

Whenever protections for secured creditors are enhanced in the chapter 11 process, such as by imposing tighter controls in DIP financing arrangements, debtors are more restricted when designing plans to achieve a successful reorganization or the most efficient and effective sale of assets. Conversely, when secured creditor protections are relaxed, such as by depriving them of the right to credit bid and exposing them to greater risk of undervaluation of their collateral, debtors and other plan proponents are afforded greater flexibility in designing chapter 11 plans. Thus, to some extent, recent Third and Fifth Circuit decisions chipping away at the right to credit bid have shifted the rights of lien holders as against the rights of financially troubled borrowers in a way that affords

229. *Id.* at 317–18.

greater flexibility to debtors. Though it is too early to know the impact of this rebalancing on the cost of credit or the behavior of secured creditors or claims purchasers—or even whether the Supreme Court will follow the lead of the Third and Fifth Circuits, rather than the Seventh Circuit, and allow all-cash bidding procedures or judicial valuation to substitute for credit bidding—the loss of the right to credit bid at plan sales tips the scales toward debtors when formulating and negotiating chapter 11 plans that provide for the sale of assets.