Credit bidding at risk?
Third Circuit rules that secured lenders do not have the statutory right to credit bid their claims

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What you need to know:
The United States Court of Appeals for the Third Circuit has ruled that secured lenders do not have a statutory right to credit bid their claims in connection with a sale of the debtor's assets effectuated through a chapter 11 plan of reorganization.

What you need to do:
At a minimum, secured lenders are advised to preserve their right to credit bid their claims – in the context of a Section 363 sale or a sale effectuated through a chapter 11 plan – in any stipulation in which they consent to the use of cash collateral or DIP financing. Secured lenders should also consider whether to condition a debtor's consensual use of cash collateral on the debtor filing its bankruptcy petition in a jurisdiction that recognizes a secured lender's right to credit bid in connection with a sale consummated in association with a chapter 11 plan.

Earlier this week, the United States Court of Appeals for the Third Circuit ruled that secured lenders do not have a statutory right to credit bid their claims in connection with a sale of the debtor's assets, free and clear of the secured lender's liens, effectuated through a chapter 11 plan of reorganization. This *Philadelphia Newspapers* decision has far-reaching implications that upset secured creditors' long-standing expectations regarding their right to credit bid and likely will dramatically diminish the leverage of a secured creditor to determine the course of a borrower's bankruptcy case.

Background

Credit bidding is the use of debt as currency in a bid to purchase assets. Imagine a lender that is owed ten dollars, and holds a security interest in all of the borrower's assets. The borrower decides to sell those assets. In the absence of higher bids, the lender offers to buy the assets for five dollars. When the borrower accepts the offer, the lender takes title to the assets and deems five of the borrower's ten dollar obligation satisfied.

Section 363(k) of the Bankruptcy Code expressly authorizes credit bidding by a secured creditor in connection with the sale of the creditor's collateral. For a secured lender, the right to credit bid is an essential component of its property interest in the collateral and is one way of ensuring that the lender has the opportunity to obtain the benefit of its bargain with the borrower. Notably, the lender can bid the full value of its claim, not simply the value of the collateral, and set that amount as the floor for other bids. To the extent that there are cash bids that exceed the amount of the credit bid, the lender reaps the benefit by being paid in full (assuming the full amount of the claim was bid). To the extent no higher bids are made, the lender obtains title to its collateral.

The Bankruptcy Code recognizes those economic expectations not only in Section 363(k) but also in the context of plans of reorganization. For example, Section 1129(b) provides that a reorganization plan can be confirmed over the objection of secured creditors – a process referred to as "cramdown" – so long as the court determines that the proposed treatment of the secured creditor's claims is "fair and equitable." Prior to *Philadelphia Newspapers* (and a relatively recent decision, *Pacific Lumber Co.*), parties generally took it for granted that – in a plan calling for the sale of a creditor's collateral free and clear of liens – the plan must permit such creditor to credit bid its claims as part of the sale in order for the plan to satisfy the "fair and equitable" standard.

The Philadelphia Newspapers case

In the underlying case, the debtors proposed a chapter 11 plan that contemplated the sale of all of their assets at a public auction free and clear of all liens to a stalking horse bidder that was largely controlled by the debtors' current and former management and equityholders. The sale to the stalking horse bidder would generate approximately $37 million in cash for the debtors' senior secured lenders, an amount far less than the amount of the senior lenders' claims. Notably, however, the bidding procedures proposed by the debtors explicitly provided that credit bidding by the secured lenders would not be permitted because the sale was to be conducted as part of a chapter 11 plan, and not pursuant to Section 363 of the Bankruptcy Code.

On appeal, the Third Circuit held in a 2-1 decision that the Bankruptcy Code provides no legal entitlement for secured lenders to credit bid at an auction sale conducted in association with a reorganization plan. The Third Circuit relied heavily on the allegedly plain language of Section 1129(b)(2)(A) of the Bankruptcy Code, agreeing with the debtors that the statute provides three distinct routes to plan confirmation. Specifically, the majority opinion held that a plan of reorganization is confirmable, notwithstanding its structure as an asset sale and the exclusion of the secured creditors' right to credit bid, so long as the proposed cash payout provided the secured lenders with the "indubitable equivalent" of their claims. In a lengthy dissent, Circuit Judge Ambro argued that any sale free and clear of liens effectuated through a plan had to comply with the specific requirements of Section 1129(b)(2)(A)(ii) and permit the secured lenders to credit bid their claims.

Perhaps more significantly, the majority opinion also signaled in a footnote that the court might be willing to place new restrictions on a secured creditor's right to credit bid in connection with a Section 363 sale. Under Section 363(k), a secured creditor has a right to credit bid "unless the court *for cause* orders otherwise." The majority rejected the secured lenders' argument that the "for cause" exemption embodied in Section 363(k) applied only to situations in which the secured creditor has engaged in inequitable conduct. Rather, the majority stated that a court "may deny a lender the right to credit bid in the interest of any policy advanced by the [Bankruptcy] Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment."

Implications of *Philadelphia Newspapers*

Prior to *Philadelphia Newspapers* and *Pacific Lumber Co.*, it was taken for granted by many parties that any plan that contemplated an asset sale had to provide secured creditors the opportunity to credit bid their collateral. That conclusion was based in no small part on the reason for mandating credit bidding outside of the plan context, which was to ensure that the secured creditor at least had the opportunity to use the entire value of its claim to set the price for the assets. Otherwise, the creditor could be deprived of the basic benefit of its bargain, as a successful bid by a third party in a lesser amount would give the creditor neither the collateral nor payment in full of its claim.

In *Philadelphia Newspapers*, that fear may materialize as the secured lenders may potentially be forced to accept payments in an amount far less than the amount of their claims and lose their collateral. As a result, the decision has upset the expectations of many secured lenders, and is a particularly unwelcome development for undersecured creditors. If the decision sticks, we anticipate that debtors will decide to implement most future sales through a chapter 11 plan rather than by way of Section 363 as a way to block secured creditors from credit bidding their claims. Indeed, the true beneficiaries of the Third Circuit's decision may be equity sponsors that are willing to invest new money to reacquire their insolvent portfolio companies. Without the minimum sale price set by the secured lender's credit bid, such equity sponsors will have greater negotiating power and may be able to reacquire their portfolio companies "on the cheap."

In light of the decision, secured lenders should consider whether to condition a debtor's consensual use of cash collateral, or access to DIP financing, on the debtor filing its bankruptcy petition in a jurisdiction that recognizes a secured lender's right to credit bid in connection with a sale consummated pursuant to a chapter 11 plan, rather than in Delaware and other jurisdictions where *Philadelphia Newspapers* is binding precedent. At the very least, we would counsel our lender clients to include a provision in their cash collateral and DIP financing stipulations expressly stating that they have the right to credit bid their claims – in the context of a Section 363 sale or a sale effectuated through a chapter 11 plan – absent a determination by the bankruptcy court that such lender has engaged in inequitable conduct.

Ultimately, the most disconcerting aspect of the Third Circuit's decision, from the perspective of a secured creditor, is the court's apparent willingness to restrict such creditor's right to credit bid in the context of a Section 363 sale. Historically, courts have applied the "for cause" exemption embodied in Section 363(k) only to situations in which the secured creditor has engaged in inequitable conduct or such creditor's liens were subject to a bona fide dispute. The majority, however, indicated that it would consider denying a secured creditor the right to credit bid – whether in the context of a Section 363 sale or a sale effectuated through a plan – "in the interest of any policy advanced by the [Bankruptcy] Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment." If this interpretation of Section 363(k) is adopted by other courts, it likely will dramatically diminish the leverage of a secured creditor to determine the course of its borrower's bankruptcy case.

The secured lenders have until June 20 to petition the United States Supreme Court for a *writ of certiorari* to review the Third Circuit's decision in *Philadelphia Newspapers*. We will keep you apprised of new developments as the implications of this decision unfold.

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