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Cutting Back on Credit Bids: *Pacific Lumber and Philadelphia Newspapers*

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Until recently, a secured creditor in the United States could be confident that it had the right to 'credit bid' in a plan of reorganisation that proposed to sell its collateral: any plan that denied that right would not be viable. This stick – 'you take away my right to credit bid in your plan and the debtor cannot reorganise' – provided important protection against the risk that the secured creditor's collateral would be undervalued.

By 'credit bidding' the face value of its claim, a secured creditor could increase the potential sales price of its collateral to the fair market value without offering any new cash. If competing bids proved inadequate, the creditor could purchase the collateral and offset the amount of its claim against the purchase price. In this way, the creditor ensures that it recovers the fair market value of its collateral.

Consider, for example, a lender that issued a USD 1 million loan secured by a mortgage on real estate with a fair market value of USD 750 000. If the borrower filed for bankruptcy relief, the lender would have an allowed claim for USD 1 million. The amount that the lender ultimately recovers on its claim, however, depends on the sales price for the real estate. In a typical bankruptcy case, the lender can expect to recover nearly 100% of the sale proceeds but, at most, a fraction of the remainder of its claim. The lender, therefore, has a strong incentive to prevent other bidders from purchasing the real estate at a discount. One way the lender can do so is by credit bidding USD 750 000 at the sale. Assuming there are no higher bids, the lender could recover the real estate and reduce its bankruptcy claim to USD 250 000. The lender could then resell the real estate for USD 750 000, or hold on to the real estate for itself.

But in 2009 secured creditors' confidence in their right to credit bid was shaken. Beginning with the Fifth Circuit Court of Appeal's decision in *Scotia Pacific Co., LLC v Official Unsecured Creditors' Committee (In re Pacific Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009), in September 2009, and continuing with the Eastern District of Pennsylvania's decision *In re Philadelphia Newspapers, LLC*, 2009 WL 3756362, No. 09-mc-178 (E.D. Pa. Nov. 10, 2009), in November 2009, a line of cases is potentially emerging that allows a plan of reorganisation to deny a secured creditor the opportunity to credit bid. Should this trend continue to develop, secured creditors will lose an important protection against undervaluation of their collateral.

I. Credit bidding under the United States Bankruptcy Code

In chapter 11 cases, an array of Bankruptcy Code provisions are implicated whenever a secured creditor asserts a right to credit bid. The starting point for analysis is Section 506. When a secured creditor's collateral is worth less than the total 'allowed' amount of its claim, Section 506(a) bifurcates the creditor's claim into secured and unsecured components.[2] The secured component of the creditor's claim is fixed in an amount equal to the value of the collateral.[3] The remainder

Notes

1 The views expressed in this article are those of the authors and do not necessarily represent the views of Orrick, Herrington & Sutcliffe LLP or any of its other attorneys or clients.

2 11 U.S.C. § 506(a)(1) ('An allowed claim of a creditor secured by a lien on property in which the estate has an interest … is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property … and is an unsecured claim to the extent that the value of such creditor's interest … is less than the amount of such allowed claim.').

3 The value of a creditor's collateral is determined 'in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.' 11 U.S.C. § 506(a)(1). For purposes of evaluating a creditor's rights under a chapter 11 plan, bankruptcy courts typically value the creditor's collateral as of the effective date of the plan. See, e.g., *In re Stanley*, 185 B.R. 417, 424 (Bankr. D. Conn. 1995) (finding that several code sections 'support an inference that the secured claim should … be valued as of (or close to) the effective date of the plan'); *Dever v I.R.S.* (*In re Dever*), 164 B.R. 132, 145 (Bankr. C.D. Cal. 1994) ('Chapter 11 expressly contemplates the stripping down of liens to the value of the collateral at the effective date of the plan

of the creditor's claim is treated as unsecured. Critically, the Bankruptcy Code strips the creditor of its lien against the collateral for that unsecured component.[4] This allows the reorganised debtor to emerge from bankruptcy with a 'fresh start', free of the burdens of its predecessor.[5]

For non-recourse creditors,[6] the next Bankruptcy Code provision to consider is Section 1111. Unlike recourse creditors, non-recourse creditors face the prospect that the unsecured component of their claim will be disallowed when their collateral is sold, leaving them with only the secured component of their claim.[7] Section 1111(b) allows non-recourse creditors to avoid this pitfall by electing to give up the unsecured component of their claim and have their total allowed claim treated as secured.[8]

Once a secured creditor's claim has been apportioned into secured and unsecured components, two provisions of the Bankruptcy Code control the creditor's ability to credit bid its claim: Section 363(k) and Section 1129(b). Section 363(k) governs in situations where the creditor's collateral is sold in a pre-confirmation asset sale conducted outside of the debtor's ordinary course of business.[9] Under Section 363(k), a creditor has the statutory right to credit bid the full amount of its allowed claim (not just the secured component) 'unless the court for cause orders otherwise'.[10] In practice, bankruptcy courts rarely find 'cause' to deny a credit bid.[11]

Section 1129(b), on the other hand, applies when a secured creditor's collateral is to be sold as part of the confirmation of a chapter 11 plan of reorganisation[12] and the secured creditor (or the class of which it is a member) has already voted against the plan. In that scenario, Section 1129(b)(1) allows the plan proponents to 'cram down' the plan over the creditor's objection but only if the plan is 'fair and equitable' to the creditor. Section 1129(b)(2), in turn, prescribes a certain threshold that a plan must meet to be considered 'fair and equitable' and lists non-exhaustive alternatives for meeting that threshold. One way that a plan can meet the threshold is by organising a sale of the secured creditor's collateral and granting the secured creditor the opportunity to credit bid. A second way a plan can meet the threshold is by providing the secured creditor with the 'indubitable equivalent' of the secured component of its claim.

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pursuant to Section 1129 ...'); *In re Bloomingdale Partners*, 160 B.R. 93, 97 (Bankr. N.D. Ill. 1993) ('[T]he debate over valuation timing has been decided ... in favor of the effective date of confirmation.').

4 See *Wade v Bradford*, 39 F.3d 1126, 1129 (10th Cir. 1994) (holding that Section 1129(b)(2)(A)(i)(I) 'appears to authorise the debtor to strip the creditor's lien down to the collateral's value'); *First Fed. Bank of Cal. v Weinstein* (*In re Weinstein*), 227 B.R. 284, 292 (B.A.P. 9th Cir. 1998) ('[Section] 506(d) operates to strip the undersecured creditor's lien from its unsecured claim, in effect reducing the creditor's lien to the present value of the collateral. '); *680 Fifth Ave. Assocs. v Mut. Benefit Life Ins. Co. in Rehabilitation* (*In re 680 Fifth Ave. Assocs.*), 156 B.R. 726, 731 n.7 (Bankr. S.D.N.Y. 1993), *aff'd*, 169 B.R. 22 (S.D.N.Y. 1993), *aff'd*, 29 F.3d 95 (2d Cir. 1994) (noting that both Section 1129(b)(2)(A)(i)(I) and Section 1111(b) support the conclusion that lien stripping occurs in chapter 11 cases). But see *Blue Pac. Car Wash, Inc. v St. Croix County* (*In re Blue Pac. Car Wash*), 150 B.R. 434 (W.D. Wis. 1992) (finding that Section 506 cannot be used to avoid liens in a chapter 11 case). *Cf. Dewsnup v Timm*, 502 U.S. 410 (1992) (holding that a debtor may not strip down a creditor's lien in a chapter 7 case).

5 See *Dever*, 164 B.R. at 143 (stating that barring lien stripping 'would, in essence, gut the sum and substance of the reorganization and rehabilitation of debt concept under the Bankruptcy Code') (internal quotation omitted).

6 'A nonrecourse creditor is a creditor who has agreed to look only to its collateral for satisfaction of its debt and does not have any right to seek payment of any deficiency from a debtor's other assets.' *680 Fifth Ave. Assocs.*, 156 B.R. at 732.

7 11 U.S.C. § 1111(b)(1)(A) ('A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless – ... (ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.'). Courts have suggested that the justification for disallowing the unsecured component of non-recourse creditors' claims is that the creditors have the ability to preserve their rights by credit bidding at the sale of their collateral. See, e.g., *In re Woodridge N. Apartments, Ltd*, 71 B.R. 189, 191-192 (Bankr. N.D. Cal. 1987) (citing legislative history and discussing the history and purpose of Section 1111(b)). As discussed below, this justification may no longer be valid.

8 11 U.S.C. § 1111(b)(2) ('If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.'); see also *680 Fifth Ave. Assocs.*, 156 B.R. at 731, n.7 ('The election allows an undersecured creditor to opt out of the lien-stripping found in § 1129 in exchange for relinquishing its deficiency claim, [and] retaining its lien for the full amount of its claim ...').

9 See 11 U.S.C. § 363(b)(1) ('The trustee, after notice and a hearing, may ... sell ..., other than in the ordinary course of business, property of the estate ...').

10 See, e.g., *Cohen v KB Mezzanine Fund II, LP* (*In re SubMicron Sys. Corp.*), 432 F.3d 448, 459-460 (3d Cir. 2006) ('It is well settled among district and bankruptcy courts that creditors can bid the full face value of their secured claims under § 363(k)... In fact, logic demands that § 363(k) be interpreted in this way; interpreting it to cap credit bids at the economic value of the underlying collateral is theoretically nonsensical.') (internal citations omitted); *In re SunCruz Casinos, LLC*, 298 B.R. 833, 839 (Bankr. S.D. Fla. 2003) (finding that the plain language of section 363(k) and the applicable legislative history clarify that a secured creditor may credit bid the entire amount of its claim).

11 *Cf. Morgan Stanley Dean Witter Mortgage Capital, Inc. v Alon USA LP* (*In re Akard St. Fuels, L.P.*), Nos. CIV.A.3:01-CV-1927-D, CIV.A.3:01-CV-2066-D, CIV.A.3:01-CV-2068-D, 2001 WL 1568332, at *3 (N.D. Tex. Dec. 4, 2001) (affirming bankruptcy court finding that cause existed to deny credit bid where secured creditor's liens were in dispute and lender could bid in cash and then recover cash after dispute is resolved); *In re* Theroux, 169 B.R. 498, 499 n.7 (Bankr. D.R.I. 1994) (holding secured creditor would not be allowed to credit bid where proposed purchase price was only a fraction of the asset's market value).

12 See 11 U.S.C. § 1123(a)(5)(D) (stating that a plan may include a 'sale of all or any part of the property of the estate, either subject to or free of any lien').

Traditionally, bankruptcy courts have found that a plan provides secured creditors with the indubitable equivalent of their claims where, for example, the plan surrendered the underlying collateral to the creditor or granted the creditor a lien in property of similar value and security.[13] In contrast, with limited exceptions, bankruptcy courts routinely denied confirmation where a plan proposed to sell a creditor's collateral without allowing it an opportunity to credit bid.[14] But that landscape has been changed by the 2009 decisions in *Pacific Lumber* and *Philadelphia Newspapers*.

II. A new model for plan sales

A. Pacific Lumber

The Fifth Circuit's decision in *Pacific Lumber* departed sharply from existing case law and affirmed the confirmation of a plan that included a sale of secured creditors' collateral without allowing the secured creditors an opportunity to credit bid. The proposed plan of reorganisation governed two separate but integrated companies. One of the debtors, Scotia Pacific LLC, was a special purpose entity formed to conduct a note issuance that was secured by, among other things, certain timberlands. Scotia Pacific's timberlands had been publicly marketed both before and during the bankruptcy case but failed to produce a firm bid. Under the plan, Scotia Pacific's timberlands were to be transferred to a new entity owned and operated by the plan proponents, a creditor and a competitor of Scotia Pacific's co-debtor. In exchange, the plan proponents pledged to contribute to Scotia Pacific's estate an amount they believed was equal to the fair market value of the timberlands.

Scotia Pacific's noteholders disputed the plan proponents' valuation of the timberlands and voted against the plan. Prior to confirmation, the bankruptcy court held a valuation hearing at which it heard testimony from no less than eight valuation experts. Ultimately, the court arrived at a valuation between the plan proponents' and the noteholders' estimates. Based on that middle ground valuation, the court found that the plan provided the noteholders with the 'indubitable equivalent' of their secured claims and otherwise was 'fair and equitable'. Accordingly, the court entered an order confirming the plan.

The noteholders obtained certification from the bankruptcy court to appeal the order directly to the Fifth Circuit Court of Appeals, bypassing intermediate appellate review at the district court level. On appeal, the noteholders, relying on long-standing precedent, argued that the plan, by depriving them of the right to credit bid for the timberlands, was, on its face, not fair and equitable. The noteholders specifically argued that the bankruptcy court could not approve a plan sale that barred credit bids because doing so would render superfluous the portion of Section 1129(b)(2) that endorses plan sales that permit credit bids. In addition, the noteholders disputed the bankruptcy court's ruling that the proposed contribution was the indubitable equivalent of their claims, emphasising that they were deprived of future increases in the timberlands' value.

Upon review, the Fifth Circuit rejected the noteholders' arguments and affirmed the confirmation order. The Fifth Circuit found that the non-exhaustive nature of the alternatives endorsed by Section 1129(b)(2) suggests that a hybrid approach also could be permitted. Acknowledging that credit bid options may be critical in some plan sales contexts (but declining to specify which ones), the Fifth Circuit held that it is not necessary to allow credit bids where the plan offered the secured creditors a cash payment. 'Whatever uncertainties exist about indubitable equivalent,' the Fifth Circuit concluded, 'paying off secured creditors in cash can hardly be improper if the plan accurately reflected

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13 See, e.g., *Sandy Ridge Dev. Corp. v La. Nat'l Bank* (*In re Sandy Ridge Dev. Corp.*), 881 F.2d 1346, 1350 (5th Cir. 1989) ('In the present case, [the secured creditor] will receive the actual property underlying its secured claim and, therefore, it is clear that it will receive the indubitable equivalent of its secured claim.'); *Brite v Sun Country Dev., Inc.* (*In re Sun Country Dev., Inc.*), 764 F.2d 406, 409 (5th Cir. 1985) (finding that twenty-one notes secured by twenty-one lots with a total value that exceeded the secured creditor's claim were the indubitable equivalent of the creditor's first lien on 200 acres of undivided land); *cf. F.H. Partners, L.P. v Inv. Co. of the Sw., Inc.* (*In re Inv. Co. of the Sw., Inc.*), 341 B.R. 298, 324 (B.A.P. 10th Cir. 2006) ('[T]rading its first lien on the most easily salable assets for a junior lien on less easily marketable assets, or a totally unsecured interest in personal property never valued by the Court, is not the indubitable equivalent of its claim.').

14 See, e.g., *John Hancock Mut. Life Ins. Co. v Cal. Hancock, Inc.* (*In re Cal. Hancock, Inc.*), 88 B.R. 226, 231 (B.A.P. 9th Cir. 1988) (affirming bankruptcy court determination that proposed plan could not be confirmed '[g]iven the Congressional intent to allow a nonrecourse creditor the right to credit bid in a proposed 'sale' of the property pursuant to plan of reorganisation'); *In re Kent Terminal Corp.*, 166 B.R. 555, 566-567 (Bankr. S.D.N.Y 1994) ('If a plan proposes the sale of a creditor's collateral free and clear of liens, the lienholder has the unconditional right to bid in its lien.'); see also *H & M Parmely Farms v Farmers Home Admin.*, 127 B.R. 644, 649-650 (D.S.D. 1990) (finding that creditor's lien attached to proceeds of sale, including any post-confirmation appreciation, where debtor denied creditor right to credit bid at post-confirmation sale of collateral). But see *Aetna Realty Investors, Inc. v Monarch Beach Venture, Ltd.* (*In re Monarch Beach Venture, Ltd.*), 166 B.R. 428, 437-438 (C.D. Cal. 1993) (remanding for further findings as to whether plan that denied creditor an opportunity to credit bid provided creditor with the indubitable equivalent of its claim); *In re CRIIMI MAE, Inc.*, 251 B.R. 796, 805-808 (Bankr. D. Md. 2000) (finding plan that denied secured creditor the opportunity to credit bid was not unconfirmable as a matter of law and still could provide the creditor with the indubitable equivalent of its claim); *In re Broad Assocs. Ltd. P'ship*, 125 B.R. 707 (Bankr. D. Conn. 1991) (finding non-recourse creditor did not have a right to credit bid at a plan sale where it had an opportunity to make an election under Section 1111(b) and it would retain a lien in the collateral, but denying confirmation on other grounds).

the value of the [n]oteholders' collateral.' As for the noteholders' allegations that the sale deprived them of future value, the court responded that the Bankruptcy Code does not protect secured creditors' upside potential, but only the value of their secured claims at the time of confirmation.

B. Philadelphia Newspapers

Not long after the Fifth Circuit issued its decision in *Pacific Lumber*, the bankruptcy court for the Eastern District of Pennsylvania received a set of proposed bidding procedures for a public auction of substantially all of the debtors' assets in the *Philadelphia Newspapers* case. The debtors had entered into an asset purchase agreement with a stalking horse bidder for what they believed was the fair market value of the assets. Through the bidding procedures, the debtors were seeking to market the offer in hand and solicit higher and better bids. Under the terms of the plan, the proceeds of the sale would go toward satisfying the claims of the debtors' significantly undersecured lenders.

A key feature of the bidding procedures was that bidders were required to fund their offers with cash. The effect of this requirement was to deny the debtors' dissenting, undersecured lenders the opportunity to credit bid. The debtors insisted that the dissenting lenders were not entitled to credit bid because the proposed plan provided the lenders with the 'indubitable equivalent' of their claims and, thus, Section 1129(b)(2) was satisfied. The debtors also argued that allowing lenders to credit bid would discourage other bidders from spending the time and money necessary to engage in the sale process.

The lenders, in opposition, argued that the proposed sale could not be approved without granting them an opportunity to credit bid. They asserted that Section 1129(b) must be read in conjunction with Section 1111(b) and, therefore, they were entitled to protect their rights either by making an election under Section 1111(b) or by credit bidding their debt. Because the lenders were recourse creditors precluded from making a Section 1111(b) election, they claimed that they had an absolute right to credit bid at the proposed auction.

The bankruptcy court agreed with the lenders and denied the requested bidding procedures. The bankruptcy court acknowledged that organising a sale that allows for credit bidding and providing creditors with the indubitable equivalent of their claims are both acceptable alternatives for satisfying Section 1129(b)(2). Nonetheless, the bankruptcy court decided that it would be 'illogical' to allow the debtors to use one alternative – providing the creditors with the indubitable equivalent of their claims – to accomplish a result that is directly contrary to another – organising a sale that allows for credit bidding. The bankruptcy court concluded that Congress intended secured creditors to have the ability to protect their rights by making a Section 1111(b) election or by credit bidding their debt. In addition, the bankruptcy court found no plausible business justification for restricting the lenders' bidding rights because any additional funds would go toward satisfying the lenders' claims anyway.

On expedited appeal, however, the district court reversed. Adhering to the rule that a statute should be afforded its plain meaning, the district court concluded that the lenders did not have a right to credit bid because the portion of Section 1129(b)(2) that allows plans to provide creditors with the indubitable equivalent of their claims does not contain a reference to credit bidding. The district court emphasised that the indubitable equivalence concept was designed to be flexible and that Congress could well have intended to give a debtor latitude to propose a sale that barred credit bidding but still generated the indubitable equivalent of the secured creditors' claims. The district court found that the overlap with the portion of Section 1129(b)(2) that allows plans to organise sales with credit bidding was not enough to negate the independence of the two alternatives. In addition, the district court rejected the bankruptcy court's holding that Section 1111(b) informs Section 1129(b), finding that the connection between the two provisions is 'at best attenuated'. The district court also noted that recourse creditors who are not entitled to credit bid could otherwise protect their rights by voting their secured and deficiency claims.

III. Looking ahead

The *Philadelphia Newspapers* decision is currently under review by the Third Circuit Court of Appeals – a particularly influential court due to the number, complexity, and significance of the bankruptcy cases filed in its jurisdiction – and the decision could be reversed. To be sure, some of the arguments that the district court rejected, including the connection between Section 1129(b)(2) and Section 1111(b), have resonated with other courts.[15] And if the Third Circuit affirms, the district court's decision remains limited in its scope. In its analysis, the district court made clear that it only was deciding whether the proposed plan *could* satisfy the fair and equitable standard as a matter of law. The court expressly reserved judgment as to whether the

Notes

15 See, e.g., *Woodbridge N. Apartments*, 71 B.R. at 192 ('[T]he purpose of [S]ection 1111(b)(1)(A) is not satisfied by a sale at which the lienholder may not credit bid.').

plan *did* satisfy the fair and equitable standard as a matter of fact. Thus, if the Third Circuit agrees that a plan can, in theory, satisfy the threshold requirement of Section 1129(b)(2) by a plan sale that denies creditors the right to credit bid, the bankruptcy court on remand still may circumscribe the situations in which a plan sale satisfies that requirement in practice.

In *Pacific Lumber*, the Fifth Circuit did make a final determination that the proposed plan was fair and equitable so the remand issue does not apply. But the *Pacific Lumber* decision may also prove limited to its facts. The judicial valuation in *Pacific Lumber* was the product of 'extensive' valuation testimony by multiple experts that followed on the heels of months of public marketing. Bankruptcy courts may be wary to extend the rule of *Pacific Lumber* to plan sales that are supported by lesser evidence. Indeed, employing a lower standard of proof would arguably be inconsistent with Congress' use of the term 'indubitable', which, as other courts have pointed out, means 'too evident to be doubted'.[16]

It remains the case, however, that when the Fifth Circuit first announced its decision in *Pacific Lumber*, the opinion was isolated in Bankruptcy Code jurisprudence. With the ruling in *Philadelphia Newspapers*, it is no longer isolated. Armed with those decisions, one can expect plan proponents to push the envelope and present plan sales that deny secured creditors the opportunity to credit bid. Should other courts follow suit and affirm such plans, the consequences for secured creditors could be significant. As the facts of *Pacific Lumber* suggest, secured creditors may find themselves deprived of the ability to take control of the sales process and forced to accept a valuation set by the bankruptcy court by reference to expert testimony. Even in public auctions, creditors could end up without any means to protect themselves against scavengers bidding on the collateral at cut throat prices.[17] And without the ability to block an unfavourable plan sale, secured creditors stand to lose much of the leverage they now have in plan negotiations. Time will tell if Pacific Lumber and Philadelphia Newspapers are the harbingers of a broad trend or will continue to represent a minority position. But this is an area secured creditors should watch closely.

Notes

16 *Arnold & Baker Farms v United States* (*In re Arnold & Baker Farms*), 85 F.3d 1415, 1422 (9th Cir. 1996) (quoting *In re Walat Farms, Inc.*, 70 B.R. 330, 334 (Bankr. E.D. Mich. 1987)).

17 This concern is slightly lessened for non-recourse creditors. A non-recourse creditor still can make a Section 1111(b) election and have its entire allowed claim treated as secured. Resources permitting, the creditor can then bid cash for its collateral. In a typical case where secured creditors are paid in full, the creditor will receive back every dollar that it bids, up to the amount of the creditor's allowed claim.

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