Bulletin

Attacks Continue on Lenders' Right to Credit Bid in 363 Sales

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Reorganization is a tough business when capital is inaccessible. It's no secret that true Chapter 11 reorganizations are few and far between; the Chapter 11 bankruptcy process is now used frequently as a sales mechanism through its very powerful Section 363 sale process. The market demands sales, and to attract the highest prices, it demands the certainty of a Section 363 sale. Indeed, from the perspective of the market, Chapter 11 may be the most efficient liquidation mechanism in the world.[1]

However, while the shift to sale cases from plan cases in Chapter 11 has been widespread, it has not been without controversy. One of the major developments of the past few years has been the attacks on a secured lender's right to credit bid, once thought to be almost sacrosanct in the bankruptcy arena. A number of recent cases have dealt with the ability of a secured lender to credit bid. Perhaps at least in part, these attacks were a reaction to the perceived abuse of sales cases, the prevalence of the relatively new loan-to-own strategy, and widespread lending abuses that led to the meltdown of Wall Street.

The 363 sale is a powerful liquidation tool. Better than the state law foreclosure process, it allows sellers to assign contracts to the buyer without having to obtain consent from the other party to the contract. Better yet, a 363 sale is memorialized by a Bankruptcy Court order, considered the closest equivalent to Kevlar in any distressed scenario. The order often explicitly cleanses the buyer and the assets from any liability to other creditors, including state law successor liabilities.

Credit bidding is the secured creditors' ultimate protection in a 363 sale. It is the right of a secured creditor to "bid" the amount of its outstanding claim at a sale of collateral. If the secured creditor has the winning bid, it simply offsets the purchase price against the existing debt — no money is required to change hands.

Credit bidding is not unique to bankruptcy. It is a typical right of a secured creditor at a foreclosure sale under state law as well. The right to credit bid prevents another bidder from buying collateral for less than the amount of the secured debt without the lenders' consent. If it finds the bid price unacceptably low, the lender simply bids in its debt at the higher amount and then takes over the collateral as the high bidder.

"Indubitable Equivalent" Attack

One of the most recent threats to a secured lender's right to credit bid at a bankruptcy auction was delivered in the *In re Philadelphia Newspapers, LLC*,[2] decision, entered by the U.S. District Court for the Eastern District of Pennsylvania in late 2009. That decision was affirmed in late March by the 3d U.S. Circuit Court of Appeals.[3]

In *Philadelphia*, the debtors proposed to sell their assets in a 363 sale as part of a bankruptcy plan of liquidation. To encourage more competitive bidding from outside parties for the debtors' assets, the bid procedures specifically provided that the secured lenders were precluded from submitting a credit bid. The Bankruptcy Court refused to allow this, finding the secured creditor had to be permitted to credit bid. On appeal, however, the U.S. District Court and the 3d Circuit Court of Appeals both found that in the context of a sale as part of a plan, the secured lender can be denied the right to credit bid.

The decision in *Philadelphia* hinged on the holding that under a plan of reorganization (or liquidation), the debtor has the right to provide the secured creditor with the "indubitable equivalent" of its claim instead of the right to credit bid.

The U.S. Bankruptcy Code provides a debtor with three options for treating a secured creditors' claim in a plan:

1. Payment of the claim over time with interest
2. The right to credit bid at a sale if the plan proposes a sale
3. The right to receive the "indubitable equivalent" of the claim[4]

Conventional wisdom generally has held that if the bankruptcy plan provides for a sale, the second option is exclusive and the secured creditor has the right to credit bid. That may not be so any longer.

Supporting the decision in *Philadelphia* are at least two other cases. The first, an older decision long considered an outlier, is *In re Criimi Mae, Inc.*,[5] a Maryland ruling from 2000. The second and more important decision is that of the 5th U.S. Circuit Court of Appeals in *In re Pacific Lumber Co.*,[6] handed down in 2009.

Pacific Lumber held that a plan could be confirmed even though it denied secured creditors the right to credit bid, as long as the plan accurately reflected the value of the secured creditors' collateral (i.e., the "indubitable equivalent"). The 5th Circuit's position is not necessarily surprising, given that the court has long been viewed as disapproving of sale cases and supportive of plans instead. Its 1983 decision in *In re Braniff Airways, Inc.*,[7] was one of the seminal holdings that a 363 sale of an entire business generally cannot be held outside of a plan. However, that decision has been rejected by courts in many other circuits, including the 3d Circuit, where *Philadelphia* was decided. See, for example, *Stephens Industries, Inc. v. McClung*, 789 F.2d 386 (6th Cir. 1986); *In re Abbotts Dairies of Penn., Inc.*, 788 F.2d 143 (3rd Cir. 1986).

Courts that are more supportive of allowing sale cases generally have been more protective of credit bidding rights because they are viewed as an essential part of the sale process. The new decision in *Philadelphia Newspapers* by the 3d Circuit, arguably the most influential appeals court in the bankruptcy arena and one that has long been seen as tolerant of sales cases, is thus more surprising.

If the trend moves away from sale cases, then secured lenders should beware. Credit bid rights will increasingly come under fire in cases in which a sale is the ultimate goal.

Loan-to-Own/Motive Attack

Another attack on the right of secured lenders to credit bid has come in response to secured creditors' attempts to execute a loan-to-own strategy, in which a party buys secured debt with the intent of taking over the borrower. The defense of unsecured creditors is often to ask that courts in this situation reject the right of the debt buyer to credit bid and instead require a debt buyer to pay in cash the value of its bid.

For example, in *In re Radnor Holdings Corp.*,[8] the official committee of unsecured creditors objected to 363 sale procedures on grounds that the secured lender should not be allowed to credit bid. Instead, the committee contended that the lender should be required to pay its bid in cash, with the sale proceeds to be returned to the lender through its distributions as the secured creditor under a plan.

In other words, the committee sought to convert the sale case into a plan case. As bankruptcy leverage goes in a plan case, the secured lender likely must agree to some distribution for the unsecured creditors to get a plan confirmed. *In Radnor Holdings*, the argument against credit bidding was unsuccessful, with the court finding that unless there were grounds for equitable subordination, the right of the secured creditor to bid at the sale was paramount. But more attacks like this are likely on the horizon.

Equitable Subordination Attack

Equitable subordination — the de-prioritizing of its claims because of outrageous conduct by a lender — is a weapon that has often been trained on secured lenders, but usually with little success. The recent and hotly reported case of *In re Yellowstone Mountain Club, LLC*,[9] is an exception, however. In that case, unsecured creditors were able to use equitable subordination to significantly curtail the right of the secured lender to credit bid.

In *Yellowstone*, Credit Suisse as the secured creditor made a $375 million loan to the debtors, despite red flags and allegedly inadequate due diligence. The court found that Credit Suisse's prime motivation for making the loan was the fees it was earning from the loan transaction and that the loan had resulted in financial ruin for the debtors. The court found the actions "so far overreaching and self-serving that they shocked the conscience of the Court."[10]

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As a consequence, the court subordinated Credit Suisse's first-lien position to that of the debtor-in-possession (DIP) lender and to the allowed claims of unsecured creditors.[11] Credit Suisse was permitted to submit a credit bid for the amount of its allowed secured claim. But because its claim was equitably subordinated, Credit Suisse was required to provide as a component of its credit bid sufficient funds to pay the DIP financing, the administrative fees and costs of the debtors' estate, and the allowed unsecured claims of many of the creditors.

'Not-So-Free/Not-So-Clear' Attack

Finally, the one decision that has struck fear in the hearts of all watchers of 363 sales and credit bids is *In re Clear Channel*.[12] In that case, the 9th Circuit Bankruptcy Appellate Panel found that a lender's successful credit bid at a 363 sale did not wipe out junior liens against the assets. The court found that it was unclear that the assets could be sold free and clear of the junior liens without the consent of the junior lenders.

While most state foreclosure laws would have allowed a sale to wipe out junior liens, the court in *Clear Channel* did not believe it was obvious that there was a similar basis for wiping out junior liens in a 363 sale. *Clear Channel* has been widely cited as a significant hurdle to future 363 sales because of its broad reasoning. On its facts, however, *Clear Channel* is simply an attack on the rights of a lender to credit bid. Whether *Clear Channel* applies in any other context is a significant question, as is whether its reasoning will be adopted by any other courts.

Continuing Threat

So, the hits just keep on coming. Attacks on credit bidding through such cases as *Philadelphia, Pacific Lumber, Radnor Holdings, Yellowstone*, and *Clear Channel* may be a reflection of distaste for sale cases in the new bankruptcy world. The market demands sale cases. But what the market demands, it does not always get. The evolution of sale cases and the continued assaults on the sanctity of the credit bid will be an area of bankruptcy law worth watching over the next few years. CR

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[1] See, *e.g.*, Domenic Pacitti, "Securing Value in Undesirable Circumstances: Why Chapter 11 May Be the Best Option for Liquidation," Morris Anderson & Company's *Renaissance* Newsletter, Fall 2009.

[2] 418 B.R. 548 (E.D. Pa. 2009).

[3] In re: *Philadelphia Newspapers, LLC*, F.3d, 2010 WL 1006647 (3d Cir. March 22, 2010).

[4] In bankruptcy, a number of things have been found by courts to be the indubitable equivalent of a creditor's claim, such as abandonment of collateral or a replacement lien on similar collateral.

[5] 251 B.R. 796 (D. Md. 2000).

[6] 584 F.3d 229 (5th Cir. 2009).

[7] 700 F.2d 935 (5th Cir. 1983).

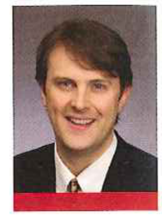
[8] 353 B.R. 820 (Bankr. D. Del. 2006).

[9] 2009 Bankr. LEXIS 2047 (Bankr. D. Mont. May 13, 2009)

[10] Id. at *25.

[11] Id. at *31.

[12] 391 B.R. 25 (9th Cir. B.A.P. 2008).



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