The Demise of Credit Bidding at Plan Sales:

So What Constitutes the "Indubitable Equivalent" of a Secured Creditor's Claim?

by Douglas M. Foley

Two recent circuit court opinions have concluded that a secured creditor's right to credit bid is no longer sacrosanct in the context of a sale proposed in a Chapter 11 plan under Section 1129 of the Bankruptcy Code.[1] Although considered in different procedural contexts, both the U.S. Court of Appeals for the Third Circuit (*Philadelphia News*)[2] and the U.S. Court of Appeals for the Fifth Circuit (*Pacific Lumber*)[3] have now ruled that Section 1129(b)(2)(A)(ii) is not the exclusive means for a debtor to sell a secured creditor's collateral under a Chapter 11 plan. Section 1129 provides in relevant part as follows:

> (b) (1) . . . the court, on request of the proponent of the plan, shall confirm the plan . . . is *fair and equitable*, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.
>
> (2) For the purpose of this subsection, the condition that a plan be *fair and equitable* with respect to a class includes the following requirements:
>
> (A) With respect to a class of *secured claims*, the plan *provides*—
>
> (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)*[4] 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.

11 U.S.C. §1129(b) (emphasis added).

When a debtor proposes to sell a lender's collateral outside of a Chapter 11 plan, § 363(k) allows the secured creditor to credit bid its secured claim. A credit bid allows a secured lender to bid its debt in lieu of cash at a sale of its collateral. The rationale for allowing a lender to credit bid is that the secured creditor likely would not outbid a cash bidder unless it thought the collateral had greater value than represented by the cash bid since its lien would typically transfer to the proceeds of sale.

While § 363(k) expressly authorizes credit bidding in sales conducted outside of a plan, both the Third Circuit in *Philadelphia News* (in the context of bidding procedures) and the Fifth Circuit in *Pacific Lumber* (in the context of plan confirmation) have recently held that there is no guarantee of a secured creditor's right to credit bid at a sale of its collateral under a Chapter 11 plan. In both cases, the debtor proposed sales or processes that expressly prohibited credit bidding.

Less than six months after the *Pacific Lumber* decision, the Third Circuit decided *Philadelphia News* in the context of bidding procedures.

In *Pacific Lumber*, a class of undersecured creditors challenged confirmation of a plan that proposed selling their collateral without allowing the opportunity to credit bid. They challenged the legality of the plan, arguing it could not be confirmed over their objection because under § 1129(b)(2)(A)(ii) (Clause (ii)) the plan had to afford them an opportunity to credit bid at the sale. The bankruptcy court overruled the objection and on appeal the Fifth Circuit, in an opinion authored by Judge Edith H. Jones — a former Chapter 11 bankruptcy practitioner — affirmed the ultimate conclusion that Clause (ii) does not provide the exclusive means for a debtor to sell collateral under a Chapter 11 plan. Instead, the Fifth Circuit focused on how to define § 1129(b)(2)(A)(iii) (Clause (iii)), which allows for confirmation over the objection of a class of secured creditors if such creditors are receiving the indubitable equivalent of their claims.[5]

The Fifth Circuit held the secured creditors did not have an automatic right to credit bid at the sale under Clause (iii) because the three prongs are joined together by the disjunctive "or" and are therefore to be viewed as alternatives, and was not persuaded by the argument that Clause (ii) applies exclusively in cases where collateral is sold under a plan. The Fifth Circuit court held that Clause (iii) — the indubitable equivalent prong – was not intended by Congress to be a "capacious but empty semantic vessel" but rather provides a separate and distinct basis for confirming a plan.[6] The court stated 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 . . . collateral" and that the Bankruptcy Code "does not protect a secured creditor's upside potential [i.e., the right to potentially increase the value of the return on its claim by credit bidding]; it protects the 'allowed secured claim.'"[7]

Less than six months after the *Pacific Lumber* decision, the Third Circuit decided *Philadelphia News* in the context of bidding procedures. The case involves several print media companies, and the debtors proposed a plan of reorganization that included a public auction of substantially all of the debtors' assets. The bidding procedures provided that all bids must be in cash and thereby prohibited credit bidding. The bankruptcy court held that when a sale is taking place pursuant to a plan, the secured creditor must be allowed to credit bid. However, relying partly on *Pacific Lumber*, the district court reversed and held that a plan may be confirmable without giving secured creditors credit bidding rights as long as one of the other prongs of section 1129(b)(2)(A) was satisfied.

In a deeply divided decision, the Third Circuit affirmed the district court, holding the three prongs of Section 1129(b)(2)(A) are written in the disjunctive and therefore the plain meaning is they are separate and distinct requirements (i.e., options) for demonstrating the plan is fair and equitable to a dissenting secured creditor class for confirmation purposes. The court rejected the argument that the specific provision in Clause (ii) referencing credit bidding with respect to sales is exclusive, absolute, or precludes confirmation of a sale plan under Clause (iii) if the dissenting secured creditor class is otherwise being provided the indubitable equivalent of their claims. The court also stated, however, that the absence of the ability to credit bid could be a factor, depending on the particular facts and circumstances, in determining whether the Clause (iii) indubitable equivalent requirement is being satisfied.

In a thorough and well-reasoned dissenting opinion, Judge Thomas L. Ambro — a former Chapter 11 bankruptcy practitioner — argued that the specific credit bidding right found in Clause (ii) is always presumptively applicable whenever a plan proposes the sale of collateral and, under such circumstances, should always govern over the more general indubitable equivalent requirement found in Clause (iii). He concluded that Section 1129(b)(2)(A) is ambiguous — given that the bankruptcy court and district court disagreed about its meaning — and is open to a more that one plausible reading. As such, he

analyzed the statute practically and in the context of other statutes (§§ 363(k) and 1111(b)) protecting secured creditors' rights. He also reviewed the legislative history and bankruptcy policy to discern congressional intent. Judge Ambro read the statute as a road map that provides different specific routes to follow, depending upon how a plan proposes to treat secured claims: Clause (i) applying when a secured creditor retains its lien, Clause (ii) applying when there is a sale free and clear of liens, and Clause (iii) applying when it is proposed that the indubitable equivalent of a secured creditor's claim be provided under the plan (e.g., abandonment, or replacement lien on similar collateral).[8] He concluded that the majority opinion's fixation on the disjunctive "or" between Clause (ii) and Clause (iii) as being a "textual show-stopper" is a grossly oversimplified analysis that undermines the design and function of the Bankruptcy Code and a secured creditor's rights under applicable nonbankruptcy law – namely, to foreclose on its collateral and credit bid at the sale.[9]

It is unclear what practical impact, if any, *Pacific Lumber* and *Philadelphia News* will have on either the credit markets or in Chapter 11 practice.[10] It is likely that more sales will be attempted, time permitting, as part of the plan confirmation process than under § 363, since debtors may have more options in disposing of encumbered assets in light of these decisions. However, many questions remain unanswered about satisfying the indubitable equivalent prong found in Clause (iii) with respect to a plan sale.

Both *Pacific Lumber* and *Philadelphia News* involved cash-only auction processes with the liens attaching to the proceeds of sale. In this context, it is arguably difficult to see how a secured creditor is harmed — provided the price obtained accurately reflects the value of the secured creditor's collateral, which might be presumed by bankruptcy courts if the collateral was sold at a properly conducted noncollusive, arms-length public auction. But what if the terms of the auction sale process were more complicated or involved different currency?

These two decisions seem to suggest that, at its core, determining a secured creditor's indubitable equivalent may involve only the valuation of the secured creditor's collateral accurately under the plan. This may be the focus of future disputes in confirmation battles yet to come. As debtors develop more creative ways to treat secured claims in Chapter 11 plans under the indubitable equivalent prong, there may be more challenges to valuation methodology, thus testing the outer reaches of what constitutes fair and equitable under § 1129(b). Unless other circuit courts follow Judge Ambro's dissenting opinion, it is unlikely that the U.S. Supreme Court will weigh in on the debate. Until then, it would be wise for secured creditors and bankruptcy courts to prepare to analyze and wrestle with a myriad potential plan treatments that attempt to further the define contours of indubitable equivalence.

Endnotes:

1 All statutory references are to the Bankruptcy Code, 11 U.S.C. §§ 101, *et seq*. unless otherwise noted.

2 *In re Phila. Newspapers LLC*, 599 F.3d 298 (3d Cir. 2010) (hereinafter "*Philadelphia News*").

3 *Bank of New York Trust Co. NA v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009) (hereinafter "*Pacific Lumber*").

4 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.

11 U.S.C. § 363(k).

5 Judge Learned Hand first coined the phrase "indubitable equivalent" in *In re Murel Holding Corp*., 75 F.2d 941, 942 (2d Cir. 1935). In interpreting the Bankruptcy Act of 1898, Judge Hand found that a secured creditor could not be deprived of his collateral "unless by a substitute of the most indubitable equivalence." *Id*. The phrase now appears in the Bankruptcy Code.

6 *Pacific Lumber*, 584 F.3d at 247.

7 *Id.* The court also suggested that the undersecured creditors' real complaint seemed to be with the Bankruptcy Court's valuation process. The court concluded, however, that the process was extensive, fair, and equitable, and thus satisfied Clause (iii). *Id.* at 249.

8 *Id.* at 337

9 *Id*.

10 Judge Ambro also surmised that the majority opinion may increase the cost of credit, since it would upset "three decades of secured creditors' expectations." *Id. at 337*.