SALES OF BUSINESSES IN INTERNATIONAL CASES: CLEAR OR NOT-SO-CLEAR TITLE?

Sales of a Going Concern Under United States Bankruptcy Law

By

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The recent sales of substantially all assets of two industrial giants, General Motors and Chrysler, at lightning speed has focused attention of bankruptcy and insolvency practitioners world-wide on the U.S. asset sale process.

Chrysler filed for relief under chapter 11 of title 11 of the United States Code (11 U.S.C. §§ 101 et seq., hereinafter the “Bankruptcy Code”) on April 30, 2009. The sale of substantially all its assets closed on June 10, 2009. The consideration was $2 billion in cash plus the purchaser’s assumption of certain liabilities. Union support was garnered by the asset purchaser (“New Chrysler”) entering into a new collective bargaining agreement with Chrysler’s principal U.S. union, the UAW. The cornerstone of the transaction was an alliance with Fiat, which obtained 20% ownership of New Chrysler, with ability to achieve 51% ownership. An employee healthcare beneficiary association obtained 55% initial ownership interest in New Chrysler and a $4.587 billion note from that entity, and U.S. and Canadian governmental entities received 17.31% of the ownership of New Chrysler. The Chrysler sale was financed principally by the United States Treasury, with support from the Canadian government -- as was the GM sale also.

General Motors filed for chapter 11 relief on June 1, 2009; the sale of substantially of its assets closed on July 10, 2009. Unlike the Chrysler transaction, the sale was by credit (not cash) bid -- which the U.S. Treasury was able to effect because, as a result of pre-bankruptcy financing of GM, the U.S. Treasury had extended a $13.4 billion in senior secured debt prepetition, plus $33 billion in secured post-petition (debtor-in-possession) financing. (The Canadian government had extended $9.1 billion in such financing.) As a result of the credit bid, upon closing of the transaction, the U.S. Treasury owned 60.8% of the common stock purchaser (New GM); the Canadian government owned 11.7% of the common stock. In addition, an employee beneficiary association established solely to pay UAW retiree benefits received 17.5% of the common stock, plus significant preferred stock and warrants. The Seller (Old GM, the debtor) received 10% of the common stock, with potential for an additional 2%.

The focus of this paper is not GM and Chrysler. But the brief recitation of the above facts serves strikingly to show the speed and flexibility available in the U.S. bankruptcy system to effect massive, complex sales. Fortunately, GM and Chrysler generated significant judicial decisions that analyzed the asset sale issues in those cases. In re General Motors Corp., 407 B.R. 463 (Bankr. S.D.N.Y. 2009); In re Chrysler LLC, 405 B.R. 84 (Bankr. S.D.N.Y. 2009), aff'd, 576 F.2d 108 (2d Cir. 2009), vacated with instructions to dismiss the appeal as moot, 130 S. Ct. 1015 (2009).1

1 Although the decision of the United States Court of Appeals for the Second Circuit (“Second Circuit,” which encompasses New York) was vacated as moot, it remains a significant statement by a leading appellate court as to the significant issues involved in the Chrysler sale.
A. **Overview and Description of Statutory Authority**  
**For Sales of Substantially All Assets As Growing Concern**

GM and Chrysler were asset sales outside the context of a chapter 11 plan. The statutory authority for such sale is section 363(b)(1) of the Bankruptcy Code, which provides in relevant part:

(b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate....

Section 363 has no limitations based on size of the transaction, although the case law has required showings that there is a “good business reason” for the sale of substantially all assets outside the plan context, e.g., Comm. of Equity Securities Holders v. Lionel Corp. (In re Lionel Corp.), 772 F.2d 1063, 1071 (2d Cir. 1983) (seminal case), and that the sale is not a sub rosa plan -- meaning that the sale does not “short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan....” Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.), 700 F.2d 935, 940 (5th Cir. 1983) (seminal case). These points are further discussed in Section C below.

In addition, asset sales, including sales of substantially all assets as a going concern, can - and often are -- effectuated through a plan of reorganization. Section 1123 of the Bankruptcy Code, which is captioned “Contents of plan,” provides that a plan may:

provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among holders of claims or interests....


However, sales of substantially all assets under Section 363, i.e., outside the context of a plan, have become increasingly common in recent years. The Second Circuit stated in Chrysler that “[i]n the twenty-five years since Lionel, § 363(b) assets sales have become common practice in large-scale corporate bankruptcies.” 576 F.3d at 115.

Part of the reason may be structural in the Bankruptcy Code. In a sale under Section 363, the trustee (or debtor in possession) has the exclusive right to ask the court to entertain and approve such a sale of assets. (A sale of substantially all assets requires Court approval because it is not in the ordinary course of a debtor’s business.) To a significant degree therefore the

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2 In a chapter 11 case, where (as is the norm) the debtor remains in possession and the court has not ordered otherwise, the debtor has the rights of the trustee. See 11 U.S.C. § 1107(a) (“Subject to ... such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation ... of a trustee serving in a case under this chapter.”).

3 The word “property” as used in § 363(b)(1) is not defined in the Bankruptcy Code; instead, state law sets the limits on what is a property interest. E.g., Butner v. United States, 440 U.S. 48 (1979). Once an interest is determined to be a property interest, Section 541 of the Bankruptcy Code gives a broad definition of whether it is included in the debtor’s estate.
trustee/debtor in possession controls the process. In the plan confirmation context, however, the trustee/debtor in possession has a 120 day exclusive period to propose a plan, and under the 2005 amendments to the Bankruptcy Code, that period can be extended (in the court’s discretion) to a maximum of 18 months after the petition filing date. See 11 U.S.C. § 1121(d). After that, any party in interest can propose a plan and thereby attempt to take control of the sale process. In addition, the maximum possible extension of the 120-day period to assume or reject leases of non-residential real property was limited in 2005 to 90 days -- making for a total (in the court’s discretion) of 210 days for assumption or rejection. See 11 U.S.C. § 365(d)(4). These time limitations exert pressure on debtors in possession to effectuate transactions while they are still in control.

A major, and perhaps more important, factor in the move toward Section 363 sales is the severity of the recent recession and its freezing of credit markets -- which left many distressed businesses unable to obtain post-petition financing. Without such financing, the only way to preserve going concern value is a relatively quick sale. However, the plan process, in contrast to a § 363 sale, is designed to be consensual; consensus (or an attempt at consensus) takes time. (Creditors vote on a plan; they do not vote on a § 363 sale, although they still can object to the sale.) Lengthy plan negotiations are typical in a large case, unless it is prepackaged (i.e., accepted by all classes of creditors before the filing of the petition as permitted by Section 1125 of the Bankruptcy Code). Twenty-five day notice periods are required both for hearing on the adequacy of a disclosure statement and for plan confirmation (see Fed. R. Bankr. P. 2002(b)), and as a practical matter, the time for solicitation of votes in a major case can add a great deal more time.

Aside from the timing and procedural aspects, there is much similarity between the sale process under § 363 and under a chapter 11 plan. In both contexts, the court will want assurance that value to the estate is being maximized -- either by an auction process, other mechanisms for solicitation of higher or better bids, or other assurance that the assets have been adequately marketed to potential buyers. In both contexts, courts will ordinarily approve detailed bid procedures and protections to assure an orderly sale process. In both contexts, the courts have power to order the sale “free and clear” of “interests” and/or “claims,” see 11 U.S.C. § 363(f)(pertaining to § 363 sales) and 11 U.S.C. § 1141(c) (“property dealt which by the plan is free and clear of all claims and interests of creditors”), although there is some controversy as to the power of the court in a § 363 sale to bar successor liability. The trend, as noted in the GM and Chrysler decisions is to permit broad protection against successor liability in a § 363 sale, as noted infra.

4 Section 363(f) of the Bankruptcy Code provides:
(f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if --
(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
(2) such entity consents;
(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
(4) such interest is in bona fide dispute; or
(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

To be clear, sales under Section 363 of substantially all assets as a going concern do present issues not present in the more traditional route of sales through plan. But there are significant issues in plan sales also. Most recently, in In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. 2010), the United States Court of Appeals for the Third Circuit ("Third Circuit," which encompasses Delaware), in a controversial ruling, held that it was possible to sell substantially all assets as part of chapter 11 plan, free and clear of liens -- without permitting secured creditors to credit bid at the sale (i.e., offset the secured creditor’s bid with the value of its lien claim, so that it need not pay cash for such claim amount). Credit bidding is established in Section 363 sales by Section 363(k) of the Bankruptcy Code. Philadelphia Newspapers construed certain chapter 11 provisions to provide a different result in a sale pursuant to a plan, as described in detail in Section D infra.

B. Nuts and Bolts

1. Bankruptcy Rule 6004 governs the notice procedures for sales outside the ordinary course of business. In turn, that Rule references Bankruptcy Rule 2002(c)(1) -- minimum 25 days notice and requirements as to information to be provided in notice. Many bankruptcy courts, including the Southern District of New York and the District of Delaware, have local rules setting forth particular sale motion and sale procedure requirements.

2. At the outset of the process, a debtor often will enter into an asset purchase agreement with a “stalking-horse bidder.” The price that the stalking horse bidder has agreed to sets the floor for other qualified bids, which will be submitted in an auction process.

3. Such potential (stalking horse) purchasers often seek break-up fees (and other bidding protection and/or expense reimbursements) to compensate them if they are unsuccessful at the auction. The bankruptcy courts have developed various approaches and standards for approval of break up fees and reimbursements. Most recently in In re Reliant Energy Channelview LP, 594 F.3d 200 (3d Cir. 2010), the Third Circuit (reaffirming prior precedent) noted that a break up fee must meet the standard for grant of an administrative expense under Section 503(b) of the Bankruptcy Code, i.e., the fee must be an actual and necessary cost of preserving the value of the estate -- which can be shown by demonstrating that (i) the break up fee is necessary to induce the bidder to bid or (ii) that the break up fee is necessary to preserve the bid.

4. Challenges to asset sales under § 363 are difficult. If the sale is closed in good faith, Section 363(m) specifically provides that an appeal is moot. To preserve an appeal, the sale must be stayed by court order. Section 363(m) provides:

The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

Recently, in *In re WestPoint Stevens, Inc.*, No. 07-4772-bk(L) (2d Cir. Mar. 26, 2010), the Second Circuit reaffirmed the breadth of Section 363(m) and explained that it moots a broader range of cases than traditional doctrines of mootness and imposes a jurisdictional limit on the court’s authority to review a sale order. But see *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (B.A.P. 9th Cir. 2008) (holding that statutory mootness under § 363(m) did not moot dispute as to whether a “free and clear” sale under § 363(f) effectively stripped a subordinate lien from real estate sold).

C. **More on Successor Liability, Lionel, and Sub Rosa**

1. **Successor Liability**

   In general, “successor liability” is a court-created concept under U.S. state (not federal) law. It is an exception to the general rule that an asset purchaser is not liable for the Seller’s debts, and its elements vary, to some extent, from state to state. In the Section 363 sale context, the issue is whether the judicial power under § 363(f) to sell assets “free and clear of any interest in such property” encompasses the power to extinguish such potential “claims” against buyer.  

   In both *Chrysler* and *GM*, where the principal concern was personal injury and product liability claims, the courts made clear that successor liability, at least as to existing claims, could be extinguished in a § 363 sale:

   In *TWA* [322 F.3d 283 (3d Cir. 2003)] the Third Circuit considered whether (1) employment discrimination claims and (2) a voucher program awarded to flight attendants in settlement of a class action constituted “interests” in property for purposes of § 363(f). See 322 F.3d at 285. The Third Circuit began its analysis by noting that the bankruptcy courts around the country have disagreed about whether “any interest” should be defined broadly or narrowly. Id. at 288-89. The Third Circuit observed, however, that “the trend seems to be toward a more expansive reading of ‘interests in property’ which encompasses other obligations that may flow from ownership of the property.” Id. at 289 (quoting 3 Collier on Bankruptcy ¶ 363.06[1]; see also George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 Am. Bankr.L.J. 235, 267 (2002) (“[T]he dominant interpretation that is § 363(f) can be used to sell property free and clear of claims that could otherwise be assertable against the buyer of the assets under the common law doctrine of successor liability.”)).

   *Chrysler*, 576 F.3d. at 124 (footnote omitted).

   As to future claims, which can arise particularly in the asbestos context, the *GM* and *Chrysler* courts declined to rule. “However, we decline to delineate the scope of the bankruptcy

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5 As noted supra, Section 1141(c) of the Bankruptcy Code expressly permits sales in the plan context “free and clear of all claims and interests of creditors.” 11 U.S.C. § 1141(c).
court's authority to extinguish future claims, until such time as we are presented with an actual claim for an injury that is caused by Old Chrysler, that occurs after the sale, and that is cognizable under successor liability law.” Id. at 127.

Future claims arise in the asbestos context because the disease may not manifest itself until many years after the exposure to asbestos dust. This fact presents a due process problem under the United State Constitution -- in general a court cannot bar a claim unless a claimant is given notice, and it is difficult to give meaningful notice to a person who may have no idea today that he will develop a disease years in the future. The solution may be appointment of a guardian ad litem or future claims representative. Cf. 11 U.S.C. § 524(g).

2. Lionel

As stated supra, a sale of substantially all assets, outside the context of a plan, requires a finding of a “good business reason.” In the seminal case, Lionel, the Second Circuit articulated multiple factors to be considered in making such finding:

[A bankruptcy judge] should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike. [A bankruptcy judge] might, for example, look to such relevant factors as the proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value. This list is not intended to be exclusive, but merely to provide guidance to the bankruptcy judge.

722 F.2d at 1071.

The bankruptcy court in GM articulated additional factors. 407 B.R. at 490. In practice, these factors give the court great discretion and serve to permit a § 363 sale when there is reasonable likelihood that material going concern value will be lost by delay of a sale.

3. Sub Rosa Plan

The sub rosa plan concept is not well-defined in the case law. It is often described by overbroad statements of principle. For example, the GM decision states that a sale may be objectionable “when aspects of the transaction dictate the terms of the ensuing plan or constrain parties in exercising their confirmation rights, such as by placing restrictions on creditors’ rights to vote on a plan.” GM, 407 B.R. at 495 (footnotes omitted). But the sale of the debtor’s principal assets as a going concern plainly does dictate terms of a plan -- the debtor will no longer be able to reorganize; certain contracts will be assumed and others rejected; significant asset may not be sold; employee benefit claims may necessarily be dealt with (as in GM and
Chrysler), and so on. Moreover, voting rights are affected, since there is no creditor vote on an asset sale.

A closer look at the case law shows that the courts appear to be most focused on protection of the distributional rights of a chapter 11 - how the sale consideration is to be distributed among creditors. As stated in GM, a § 363 sale “may be objectionable as a sub rosa plan if the sale itself seeks to allocate or dictate the distribution of sale proceeds among different classes of creditors.” 407 B.R. at 495 (footnote omitted).

Even then, one can say (as an objecting secured creditor did say in Chrysler) that the asset purchaser’s decision to assume liability for significant unsecured debt of the seller violates the rule of absolute priority (by paying unsecured debt in preference to secured debt) or the principle of equality of distribution (by in effect paying a higher fractional distribution to a preferred unsecured creditor). In effect, this happened in Chrysler, when the purchaser (New Chrysler) undertook to satisfy employee healthcare benefits by giving 55% of the common stock plus a $4.58 billion note to an employee benefit plan -- a major creditor of Old Chrysler. There is no easy answer. New Chrysler doubtlessly needed labor cooperation to continue as a going concern. The court rationalized the result by saying the equity stakes in New Chrysler were attributable to new value being given: “[A]ll the equity stakes in New Chrysler were entirely attributable to new value - including governmental loans, new technology, and new management -- which were not assets of the debtor’s estate.” Chrysler, 576 F.3d at 118.

D. Plan Sale Issues: Philadelphia Newspapers

In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. 2010), upholds bid procedures under which the debtor’s assets would be sold, as part of a chapter 11 plan, free and clear liens, without permitting the secured creditors to credit bid. This decision has provoked a firestorm of articles and comments because it upsets long settled practice and understanding - that a secured gets to credit bid up to the value of its total claim, thereby setting the floor on other bids and permitting the creditor to take its collateral if the bids are (in its view) inadequate. See Cohen v. KB Mezzanine Fund II, L.P (In re Submicron Systems Corp.), 432 F.3d 448 (3d Cir. 2006).

The lenders’ claim in Philadelphia Newspapers was approximately $318 million, secured by first priority liens on substantially all the debtors real and personal property. The plan provided for the assets to be sold at public auction free of liens. An agreement with a Stalking Horse Bidder, majority-owned by insiders of the debtors, provided for a sale that would generate $37 million in cash for the lenders; under the plan the lenders would also receive debtors’ Philadelphia headquarters (which the debtors’ valued at $29.5 million) -- but subject to a two-year rent free lease to the entity that will operate the newspaper.

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The matter before the court was not plan confirmation -- no confirmation hearing had yet been held. Instead, the matter before the court was a motion to approve bid procedures, with no provision for a credit bid. The focus of Philadelphia Newspapers is Section 1129(b)(2)(A) of the Bankruptcy Code, which specifies the means by which a reorganization plan can be confirmed over objection of secured creditors, i.e., a "cramdown." Section 1129(b)(1) requires the court to assess whether the proposed treatment of the secured claims is "fair and equitable" to effect a cramdown.

Section 1129(b)(2)(A) provides three circumstances under which a plan is 'fair and equitable' to secured creditors:

(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) 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

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


The three subsections of § 1129(b)(2)(A) each propose means of satisfying a lender's lien against assets of the bankruptcy estate. Subsection (i) provides for the transfer of assets with the liens intact and deferred cash payments equal to the present value of the lender's secured interest in the collateral [transfer with lien intact]. Subsection (ii) provides for the sale of the collateral that secures a lender free and clear of liens so long as the lender has the opportunity to 'credit bid' at the sale (i.e., offset its bid with the value of its secured interest in the collateral) with the liens to attach to the proceeds of the sale [sale free and clear with right to credit bid].

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7 The right to credit bid is found in § 363(k) and explicitly incorporated into subsection (ii). 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.

Subsection (iii) provides for the realization of the claim by any means that provides the lender
with the 'indubitable equivalent' of its claim [realization of indubitable equivalent]. See
Philadelphia Newspapers, 599 F.3d at 305.

Philadelphia Newspapers was a 2-1 decision, with Judge Thomas Ambro dissenting.
(The majority decision affirmed the district court, which had approved the bid procedures at
issue; the dissent sided with the bankruptcy court, which had rejected the bid procedures.)

1. The Majority Decision

The majority takes a “plain language” approach to statutory construction. Specifically,
each of the alternatives in Section 1129(b)(2)(A) are separated by the word “or”; and Section
102(5) of the Bankruptcy Code provides that the connector “or” is “not exclusive.” “Thus,
[according to the majority] any doubt as to whether subsections (i), (ii) and (iii) were meant to be
alternative paths to meeting the fair and equitable test of Section 1129(b)(2)(A) is resolved by
the Bankruptcy Code itself. . . .” 599 F.3d at 305.

Under this reasoning, the third prong of Section 1129(b)(2)(A) -- realization of the
“indubitable equivalent” of the claim -- was clearly intended to be an alternative to a sale with
opportunity for credit bid under Section 1129(b)(2)(A)(ii). But the majority still had to resolve
whether the phrase “indubitable equivalent” -- the alternative to a sale with credit bid right --
unambiguously excluded the right to credit bid. The majority noted that this phrase had been
“infrequently employed in popular parlance” (599 F.3d at 310) and had been coined by Judge
Learned Hand in In re Murel Holding Corporation, 75 F.2d 941, 942 (2d Cir. 1935). In that
decision, Judge Hand ruled that a plan’s promise to a mortgagee of a balloon payment ten years
after plan confirmation, with no amortization, as treatment for a claim that had little collateral
cushion over the present value of the debt, would not support continuation of a stay of
foreclosure. “[P]ayment ten years hence is not generally the equivalent of payment now.” Id.

Ironically, Judge Hand coined the phrase in order to strengthen the secured creditor’s
statutory right to “adequate protection,” which Judge Hand found to be “so vague a [legislative]
grant.” In re Murel Holding Corp., supra, at 942. Judge Hand ruled that the foreclosure should
not be stayed unless the creditor was provided “a substitute of the most indubitable equivalence.”
Id. Presumably the creditor in Murel Holding did get the right to credit bid at the foreclosure;
Judge Hand certainly did not address the circumstances in which a secured creditor would not
have the right to credit bid in a bankruptcy court sale.

The majority also found support in (i) the recent Fifth Circuit decision in In re Pacific
Lumber Co., 584 F.3d 229 (5th Cir. 2009) (upholding a plan that cashed out a secured lender on
the basis a valuation of collateral determined by the Court without any auction), see Philadelphia
Newspapers, 599 F.3d at 309;9 (ii) authority that the “indubitable equivalent prong of Section
1129(b)(2)(A) had been used to uphold replacement liens on similar collateral and abandonment
of collateral to the secured creditor, id. at 311; and (iii) the fact that Section 363(k) itself permits

8 See also In re CRIMI MAE, Inc., 251 B.R. 796 (Bankr. D. Md. 2000), which is also relied on by the majority
(Slip. Op. at 25, 28), but as pointed out by the dissent, is distinguishable because it involved provision of substitute
collateral (Dissent Op. at 10 n.7).
the court to bar credit bidding -- such bidding being permitted unless the court “for cause orders otherwise[,]” id. at 315-16.9

Finally, the Third Circuit majority turned to legislative intent, although this step was technically unnecessary to its plain language analysis -- and here the court finally got to the essence of the secured creditors' position. Specifically, there are at least two statements in the Congressional Record indicating that Section 363(k) of the Bankruptcy Code should work in tandem with Section 1111(b) of the Bankruptcy Code to afford such creditor the right to either to keep its lien in tact (if the property was not to be sold) or credit bid its debt (and take the property), if the property was to be sold clear of the lien. (Under Section 1111(b) of the Bankruptcy Code, a secured creditor, with recourse against the debtor, can elect to forego an unsecured deficiency claim and retain its lien as if fully secured (i.e., the creditor retains a lien for the full value of its claim, including any deficiency claim), provided that the collateral is not to be sold under Section 363 or under a plan.10)

The Third Circuit majority, however, rejected this argument. It disagreed with the notion that lien preservation (if the collateral is not sold) and credit bidding (if the collateral is sold free and clear of the lien) are basic secured creditor protections preserved by the Bankruptcy Code. “It is perhaps this point upon which our opinion the dissent must fundamentally diverge. The dissent notes a variety of rights enjoyed by secured creditors under ‘longstanding nonbankruptcy law’ -- most notably the right to foreclose in the event of default -- and then argues that ‘Congress extended this protection within bankruptcy.’” Philadelphia Newspapers, 599 F.3d at 316 n.15. “As the Court noted in Pacific Lumber, a secured lender’s expectation of benefiting

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9 There are only a few cases where the courts have disallowed a secured creditor from credit bidding -- and then only because of bona fide disputes as to the lien or issues as to misconduct. In re Antaeus Tech. Servs., Inc., 345 B.R. 556 (Bankr. W.D. Va. 2005); In re Aloha Airlines, Inc., No. 08-00337, 2009 WL 1371950 (Bankr. D. Haw. May 14, 2009); In re Diebafi Bancroft, No. 92-3744, 1993 WL 21423 (E.D. La. Jan. 26, 1993); In re Theroux, 169 B.R. 498, 499 n.3 (Bankr. D. R.I. 1994).

10 The full text of Section 1111(b) reads:

(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 --

(i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or

(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.

(B) A class of claims may not elect application of paragraph (2) of this subsection if --

(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or

(ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.

(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.

from eventual appreciation of collateral (the so-called ‘upsale’ of the collateral) is not an entitlement when the property is part of a bankruptcy estate.

2. The Dissent

The dissent focused, first of all, on the facts, specifically a “Stalking Horse Bidder [that] is seeking to pay as little as possible to obtain the assets ‘on the cheap’. . . .” Id. at 320. “[C]redit bidding is a form of protection for the secured creditor, not the debtor.” Id. at 336. “Any undervaluation of the collateral does not benefit the secured lenders here, as they only receive the sale proceeds plus a building encumbered by a two-year, rent free lease (chutzpah to the core). It does not even benefit the unsecured creditors, as their recovery is independent of the sale price.” Id.

Facts do (and should) inform the law. From this foundation, the dissent easily made the point that there are instances in the Bankruptcy Code where context requires that the word “or” be read as denoting mutually exclusive options. The dissent then turned to an accepted canon of statutory construction -- “that a specific provision will prevail over a general one.” 599 F.3d at 328. “To use clause (iii) [indubitable equivalent] to accomplish a sale free of liens, but without following the specific procedures prescribed by clause (ii) [sale free and clear of liens], undoubtedly places the two clauses in conflict.” Id. at 329. The dissent stated:

Inasmuch as the majority argues that clause (ii) does not operate as a limitation on clause (iii) because they are not in conflict, Maj. Op. at 308-09 & n.8, I do not understand how that can be the case here. Clause (ii) requires a presumptive right to credit bid at a plan sale free of liens; as construed by the majority, clause (iii) can be used in a plan sale free of liens without a right to credit bid. When one clause makes the right presumptive, and the other makes that right nonexistent, and both are believed to govern an otherwise identical sale scenario, there is undisputably a conflict between the construction of the provisions.

Id. at 330.

The dissent further noted that a second cardinal principle of statutory construction is that “no provision ‘shall be superfluous, void or insignificant.’” 599 F.3d at 330. “A presumptive right to credit bid [clause (ii)] would not need to be specifically mentioned [in § 1129(b)(2)(A)] if, as the majority believes, it was not a requirement of a plan sale free of liens.” Id.

Finally, the dissent stressed that the context of the statute should clarify its meaning and that § 1129(b)(2)(A) should be viewed “as a part of a coherent whole -- the Bankruptcy Code.” Id. at 331. The dissent finds an overarching interest in the Bankruptcy Code to protect the secured creditor against potential undervaluation of its collateral. “Considering § 1129(b)(2)(A) in conjunction with §§ 363(k), 1111(b) and 1123(a)(5)(D), their context expresses the overall policy of Congress with respect to secured creditors whose collateral is to be sold free of liens. They are part of a comprehensive arrangement enacted by Congress to avoid the pitfalls of undervaluation, regardless of the mechanism chosen. . . .” Id. at 334. The dissent found express
support in the legislative history, which states that sales under § 363 or under a plan are excluded from § 1111(b) protection because of the secured party’s right to credit bid under § 363(b). Id. at 335.

3. The Upshot

1. It bears emphasis that Philadelphia Newspapers did not decide whether the consideration being offered -- including the building with 2 years’ of free rent for the insider Stalking Horse -- was in fact the indubitable equivalent of the claim. 599 F.3d at 308 n.8. It only upheld the bid procedure. Philadelphia Newspapers thus opens the prospect in that case, and in cases to follow, of significant litigation over what is, and is not, an indubitable equivalent.

2. The Philadelphia Newspapers plan does include an auction, and therefore the lenders can cash bid to protect their interests. Whatever they bid sets the value of their collateral, and they should get it back in the free and clear sale. The Philadelphia Newspapers decision may spur lenders to revise syndication and participation documents to facilitate cash bids on behalf of lending groups.

3. In contrast to Philadelphia Newspapers, the recent Fifth Circuit Pacific Lumber decision approved a cash out sale without credit bidding right, and it approved the cash offered in the plan as the “indubitable equivalent” to the secured creditors’ claim based on a contested valuation hearing -- dealing with the value of a large tract of forest. Lenders therefore, must be prepared to advance arguments, including under the theory of Bank of America v. 203 North LaSalle Street Partnership, 526 U.S. 434 (1998), in order to at least preserve an auction and the opportunity to cash bid.

4. Lenders will doubtless consider limitations in consensual cash collateral orders to eliminate debtor’s ability to utilize the indubitable equivalent prong of § 1129(A)(2)(b) to eliminate auction and/or credit bidding rights. See In re Capmark Fin. Group Inc., No. 09-13684, 2009 WL 5190582 (Bankr. D. Del. Dec. 22, 2009), for example of such provision.