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Philadelphia Newspapers: Consideration Of Fairness?

Law360, New York (May 10, 2010) -- The monumental decision handed down by the Third Circuit Court of Appeals on March 22, 2010, in the Philadelphia Newspapers[1] case has been the subject of much commentary. The Third Circuit ruled in this decision that, under the Bankruptcy Code, § 1129(b)(2)(A), there is no right for a secured creditor to credit bid. Looking at the dissenting opinion and the Supreme Court's decision in 203 North LaSalle,[2] which considered the fundamental fairness that should be considered in a bankruptcy sale, was Philadelphia Newspapers correctly decided? Did the court adequately consider equity and fairness in making its ruling?

In Philadelphia Newspapers, the secured lenders had a first priority lien on all of the debtors' real and personal property assets. The debtors' bankruptcy plan provided that all assets were to be sold at auction, free of all liens. The court ultimately held that the language in the code was unambiguous and the secured lenders had the right to receive the indubitable equivalent[3] of their secured claim but did not have a right to credit bid.[4]

In order to examine the fairness of the Philadelphia Newspapers decision, it is first necessary to review the majority opinion, which begins by employing a statutory analysis of 11 U.S.C. § 1129(b)(2)(A). The majority opinion presents a very textualist analysis of the statute based on a strict reading of the statutory language without placing emphasis on equitable facts or considering fairness to the secured lenders.[5]

In fact, the court's focus was obvious just from looking at the way the court framed the issue at the outset of the opinion — "[w]hether Section 1129(b)(2)(A) of the Bankruptcy Code requires that any debtor who proposes, as part of its plan of reorganization, a sale of assets free of liens must allow creditors whose loans are secured by those assets to bid their credit at the auction." (emphasis in original).[6] The majority is quick to point out that this provision of the Code is not ambiguous.

More importantly, the majority opinion does not consider the effect the opinion will have on the secured lenders in this case, stating the secured lenders "may only assert a right to credit bid under subsection (iii) if that right is contained in the plain language of the statute."[7]

The majority opinion does not delve into the consequences of holding that there is no right to credit bid and also does not focus on the effect the decision will have on the secured lenders and the credit markets in the future. The majority opinion further points out that, with regard to the value of the secured lenders' claim, "it is the plan of reorganization, not the auction itself, that must generate the indubitable equivalent" and the lenders have the right to object to the plan at confirmation.[8]

Additionally, with regard to protecting the secured lenders, the majority opinion makes it clear that the Bankruptcy Code (at least their interpretation of it) does not protect the "upside" of foreclosing lenders but rather the purpose of the Code is to "cleanse" the debtor's property of hidden liens, presenting a very anti-secured creditor stance.[9]

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In contrast, the very lengthy and well-reasoned dissenting opinion offers a different perspective on the issues presented in Philadelphia Newspapers, focusing on fairness and equitable concerns, quickly pointing out at the beginning of the opinion key facts that the majority opinion omits, including that the debtors were engaged in a "Keep It Local" campaign presumably to gain support for the "local" stalking horse bidder, which is largely made up of current and former management and equity holders of the debtors or "insiders" which is typically subject to heightened scrutiny (a fact that the main opinion also glosses over). The dissent also points out early in the opinion that the debtors have offered two years of free rent on the building to be leased to the stalking horse bidder.[10]

Unlike the majority opinion, the dissent takes the position that § 1129(b)(2)(A) is ambiguous, pointing out that the bankruptcy court and district court both came to opposite conclusions about its meaning.[11]

The dissent also focuses more on the effect the denial of credit bidding will have on the secured lenders, pointing out that the stalking horse bidder is attempting to obtain the assets "on the cheap" and, by eliminating the right to credit bid, the debtors can steer the sale to a desirable purchaser — in this case, the debtors' insiders.[12]

The dissent points out that the Code was meant to protect a lender's right to foreclose and that secured creditors have a bargained-for interest in property and a right to protect that interest, which is lost if the secured creditor is not permitted to credit bid. The dissent even goes one step further and discusses the "value" of the plan relative to the amount of the loan, pointing out that the secured claimant is owed $295 million plus interest and the stalking horse bid is at $41 million, a calculation that the majority opinion indicates is "irrelevant."[13] Finally, the dissent focuses on the long line of cases that discuss the fundamental fairness and protection of the secured lenders' bargain.[14]

Similar in reasoning to the dissent in Philadelphia Newspapers, in the 203 North LaSalle case, which dealt with the cram down of unsecured debt, the United States Supreme Court focused more on the fairness and equitableness of the plan than the court in Philadelphia Newspapers, holding that impaired creditors could not receive ownership interests in the reorganized debtor without allowing competitive bidding.

The court looked at the issue of valuation of the creditors' property, determining that the "best way to determine value is exposure to the market."[15] The court also indicated that courts should stay out of valuation judgments — these judgments should be up to the creditors who should decide if they should accept or reject a plan based on adequate protection.

The court ultimately concluded that valuation should be the result of competitive choice when applying § 1129(b)(2)(B)(ii) and the result of a market valuation.[16] The court left open the question of whether market choice includes the opportunity to offer competing plans or bidding but did hold that "plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii)."[17]

Regardless of whether the debt is secured or unsecured, the inference that can be drawn regarding the issue of cram down is that the United States Supreme Court in 203 North LaSalle believed it important and necessary to prevent a slanted playing field where the plan proponent can simply force the dissenting creditors to accept whatever valuation method the debtors want for the creditors' claim. In 203 North LaSalle, the court ultimately required the opening of exclusivity or an auction to even the playing field. The court, therefore, seems to suggest that competitive bidding should be permitted based on looking at equity and fairness to both the debtors and the creditors.

From looking at the Philadelphia Newspapers decision and its dissent and the United States Supreme Court precedent in the 203 North LaSalle case, the Supreme Court may hold differently than the Third Circuit if ever faced with the issue of the right to credit bid under the Code, agreeing with the Philadelphia Newspapers dissent

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that fairness to creditors should be weighted more heavily and ultimately holding that a sale through a bankruptcy plan must be subject to some form of competitive bidding.

This, ultimately, may result in overturning the Third Circuit's opinion and a ruling in favor of the secured lenders, interpreting the Code as allowing credit bidding. Even though the make-up of our Supreme Court currently is drastically different than it was in 1999 when 203 North LaSalle was decided,[18] the case may still provide some guidance on potential issues that will face the court when (and if) they decide a similar issue in the future.

The ultimate impact of the Philadelphia Newspapers decision, if not appealed, will likely change not just bankruptcy procedure going forward for debtors and lenders but may also impact the credit markets. First, there may be more sales under a bankruptcy plan prohibiting credit bidding rather than sales under §363 of the Code.

Additionally, a secured lender who is prohibited from credit bidding may have no choice but to bid with cash at the auction, like the lenders in Philadelphia Newspapers. Finally, the decision may ultimately increase confirmation litigation for those secured lenders who were prohibited from credit bidding and who do not believe they will receive the "indubitable equivalent" for their secured claim.

In addition to the impact on bankruptcy procedure, the passage of time will determine the impact of the Philadelphia Newspapers decision on the credit markets. First, it seems that lenders may now try to include provisions in their financing contracts that require a sale through a §363 sale rather than through a plan to allow credit bidding. Second, as the dissenting opinion points out, holding that a secured lender does not have a right to credit bid "forces future secured creditors to adjust their pricing accordingly, potentially raising interest rates or reducing credit availability to account for the possibility of a sale without credit bidding."[19]

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[1] In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. 2010).

[2] Bank of America Nat'l Trust & Sav. Ass'n v. 203 North LaSalle Street P'ship, 526 U.S. 434 (1999).

[3] Indubitable equivalent means "the unquestionable value of a lender's secured interest in the collateral." Id. at 310.

[4] After this decision, the Unsecured Creditor's Committee filed a motion for rehearing on April 1, 2010, requesting that the entire Third Circuit appellate panel hear the case. This motion was denied, and the auction was scheduled to take place on April 27, 2010. As of the date of this article, there has been no appeal to the United States Supreme Court. The auction began at 3:45 a.m. on April 28, 2010 with three approved bidders--the stalking horse bidder, the secured lenders (as a cash, not credit, bid), and Stern Partners, Inc., which, as of this writing, did not make a bid but is permitted to re-enter the auction at any time.

[5] The majority relies on a United States Supreme Court decision regarding statutory interpretation of ERISA. Philadelphia Newspapers, at 307, citing Varity Corp. v. Howe, 516 U.S. 498, 511 (1996) and a Fifth Circuit decision. See Bank of New York Trust Co. v. Official Committee of Unsecured Creditors (In the matter of the Pacific Lumber

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Co.), 584 F.3d 229 (5th Cir. 2009). The majority does cite to 203 North LaSalle, but not for any of the court's critical arguments. See Philadelphia Newspapers, at 303, 314.

[6] Philadelphia Newspapers, at 300. The court further rebuts the secured lenders' arguments by arguing that the plain language of the Code does not allow for the lenders' interpretation. Id. at 315.

[7] Id. at 314 (emphasis in original).

[8] Id. at 311, quoting the lower court. The court further stated that it was not in a position to determine whether the "indubitable equivalent" test would be met at the auction, which begs the question, what happens if it is not met and the lenders object at plan confirmation?

[9] Id. at 315, citing Pacific Lumber Co., 4 F.3d 229 (5th Cir. 2009); In re Airadigm Comms., Inc., 519 F.3d 640, 640 (7th Cir. 2008).

[10] Id. at 320 (although this fact is mentioned briefly in the majority opinion. See Id. at 302).

[11] The majority opinion indicates that a statutory opinion is not ambiguous simply because there are differing interpretations of its meaning. Id. at 314.

[12] Id. at 320.

[13] Id. at fn 10.

[14] Id. at 324.

[15] 203 North LaSalle, at 457.

[16] Id. at 457.

[17] Id. at 458.

[18] At the time 203 North LaSalle was decided, Justices Souter, Rehnquist and O'Connor were all presiding. Now, these Justices will be absent from the panel and, instead, Justices Alito and Sotomayor take their places.

[19] Philadelphia Newspapers, at 337.

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