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In Re Philadelphia Newspapers, LLC – Uprooting Three Decades of Secured Creditor's Expectations?

Overview

Credit bidding by a senior secured creditor—offsetting the amount of the creditor's debt against the purchase price instead of bidding in cash for the sale assets – is a right guaranteed by statute (Section 363(k)) in sales under Section 363 of the Bankruptcy Code, except in extraordinary situations when the bankruptcy court, for "cause," specifically orders otherwise. A senior secured creditor's right to credit bid in a typical Section 363 sale, among other benefits, empowers the creditor to protect itself against any perceived undervaluation of its collateral, whether by the market or otherwise, by being able to bid up to the full amount of the creditor's debt for the collateral, even where the fair market value of the collateral is less than the amount of such debt, if the Section 363 sale process does not produce a sale price from a third party bidder that is otherwise acceptable to the creditor. *See, e.g., In re SubMicron Systems Corp.*, 432 F.3d 448 (3d Cir. 2006).

Yet, what if a bankruptcy sale is not to be conducted as a stand-alone Section 363 sale, but pursuant to a Chapter 11 plan of reorganization? Does the secured creditor retain its right to credit bid with respect to such a sale?

Under the "cramdown" provisions of the Bankruptcy Code, which are set forth in Section 1129(b)(2)(A), a Chapter 11 plan of reorganization can be confirmed over the objection of a class of secured creditors only if (i) the class retains its lien on its collateral to the extent of the allowed amount of the class claim and will receive deferred cash payments totaling the amount of the class claims and with a present value equal to value of the collateral, (ii) the collateral is sold pursuant to the plan, but subject to the right of the class to credit bid under Section 363(k), *or* (iii) the plan provides "for the realization by such [class numbers] of the indubitable equivalent of such claims."

Because one of these three cramdown standards expressly and specifically requires the recognition of a secured creditor's right to credit bid in bankruptcy sales, doesn't that ensure that a secured creditor's right to credit bid will be equally operative even where the sale is pursuant to a plan of reorganization? For at least one panel of the Third Circuit, in *In re Philadelphia Newspapers, LLC*, __ F.3d __, 2010 WL 1006647 (3d. Cir. Mar. 22, 2010) (*Philadelphia Newspapers*), the answer is "no," it does not.

In *Philadelphia Newspapers*, the plan under consideration provided for an auction sale of the Debtors' assets based on a "stalking horse" bid by current and former insiders of the debtors. The plan further provided that the headquarters building (subject to a two-year free rent concession in favor of the purchaser) and the net sale proceeds from the auction (a distribution initially valued at approximately $66 million), plus the net cash proceeds from any higher bid, would be transferred to the secured lenders towards satisfaction of their $300 million claim. The accompanying bidding procedures expressly prohibited the secured lenders from credit bidding their $300 million claim at the auction sale.

In refusing to confirm the plan, the bankruptcy court had ruled that Section 1129(b)(2)(A)(ii) required that the secured lenders be permitted to credit bid at the proposed sale, noting in passing that the court could

"discern no plausible business justification" for depriving the secured lenders of their right to credit bid, but that the preservation of that right instead appeared warranted to ensure the fairness of the sale process under the insider-driven circumstances of that case. The district court, acting as an intermediate appellate court, reversed the bankruptcy court's decision, and the secured lenders then appealed to the Third Circuit. On March 22, 2010, the Third Circuit issued a 2-1 decision affirming the district court.

In affirming the district court's reversal of the bankruptcy court's decision, the issue for the panel majority was one of statutory construction. The panel interpreted the "or" in Section 1129(b)(2)(A) to be disjunctive (i.e., at the election of the plan proponent), meaning that the proponent of a plan is not statutorily required to comply with Section 1129(b)(2)(A)(ii) and preserve a secured creditor's right to credit bid at a sale when it proposes a plan providing for the sale of a secured lender's collateral.

According to the majority's analysis, the proponent can propose a plan that prohibits the secured lender from credit bidding at the sale if the proponent can otherwise show that, consistent with the requirements of Section 1129(b)(2)(A)(iii), the secured creditor nonetheless will still realize the "indubitable equivalent" of its claims – which the panel interpreted to mean the unquestionable value of a lender's secured interest in the collateral – by virtue of the proposed sale. The majority was careful not to rule that the plan at issue would in fact provide such an "indubitable equivalent" to the secured lenders. That issue would be determined before the bankruptcy court in subsequent proceedings. The majority ruled instead that it was "simply not in a position at this juncture to conclude, as a matter of law, that this auction cannot generate the indubitable equivalent of the Lender's secured interest in the Debtor's assets."

In a lengthy dissent, Judge Thomas Ambro disagreed with the majority's statutory analysis, instead relying on textual analysis, an application of canons of statutory construction, the consideration of other relevant Bankruptcy Code provisions, and a review of legislative history to conclude that the possible cramdown of any plan proposing a sale of a secured lender's collateral can be evaluated only under Section 1129(b)(2)(A)(ii) and accordingly, could be confirmed only if it preserved the creditors right to credit bid (subject to the provisions of Section 363(k)). Judge Ambro also opined that the majority's decision will erode a fundamental secured creditor protection.

In his dissent, Judge Ambro submits that the right to credit bid has been an important protection for secured creditors by acting both as a check on the integrity of the sale process itself by preventing the stalking horse purchaser (particularly one controlled or otherwise preferred by insiders or former insiders of the debtors) from acquiring the assets "on the cheap" and as an ultimate safety valve for the secured lenders if, for whatever reason, the sale process is undervaluing collateral. Judge Ambro further submits that, as a result, secured lenders often have relied on their ability to credit bid when extending credit to debtors and have priced their loans in accordance with their bargain. While acknowledging that there might be other ways that a secured creditor theoretically may protect itself from these risks (e.g., make a cash bid for the assets), he discounts that these other methods consistently will have the utility provided by the right to credit bid. Accordingly, in his view, the majority's decision likely will lessen the likelihood that secured lenders will receive payment of the full value of their collateral and "uproots" at least 30 years' worth of "settled expectations" of secured lending.

It is too early to form any judgment as to the ultimate precedential effect of this decision. For example, courts in other circuits, based on the strength of Judge Ambro's dissent or their own analysis of the statute, might decline to follow it.

Moreover, even if the decision is not reconsidered or reversed, it eventually might have limited effect in the underlying case itself as the bankruptcy court subsequently might conclude that the proposed sale, based on the circumstances of the case, will not provide the secured lenders with the "unquestionable value" of the lender's interest in the collateral and thus, will not permit the secured lenders to realize the "indubitable equivalent" of their claims, requiring that confirmation be denied.

Also, it ultimately may not have a material effect on the rights of secured creditors even in other cases where the decision has precedential weight or otherwise is purported to be followed. This could be the case because the plan proponent on the facts of that case cannot carry its burden to satisfy the other statutory requirements for confirmation of a plan or to prove that the proposed sale will provide the secured lenders with the "unquestionable value" of their collateral. Also, the auction process that the decision contemplates might produce a fair market value for the collateral that proves acceptable to the secured lenders or the secured lenders could elect to protect themselves from any undervaluation risk by bidding cash for their collateral as part of such sale process, secure in the knowledge that such case payment would "round trip" back to them in the form of a distribution of sale proceeds on this secured claim. Because of the type of assets involved, either of these results would appear to be particularly likely in the context of a single asset real estate case, for example, especially (in the case of the senior secured lenders making a cash bid for their collateral) where non-securitized debt is involved.

However, the panel's decision (if followed) nonetheless likely will have the effect of changing the dynamics of bankruptcy cases where the secured lenders are undersecured by tilting the bargaining leverage away from the secured lenders, who must now arguably weigh whether a debtor will be able to propose a plan of reorganization that provides for a sale of its collateral and that bars the secured lender from credit bidding at the sale to the lender's detriment and that has a colorable chance of being confirmed by the bankruptcy court over the secured lenders' objection. Whether such a tilting of leverage likely may result in a transfer of material value (or instead, of only immaterial or no value) away from the secured lenders to the putative purchaser (or some other party) will depend, as noted above, on the circumstances of a particular case.

Discussion

APPLICABLE BANKRUPTCY LAW

The discrete question presented in *Philadelphia Newspapers*—whether credit bidding (as provided in (Section 363(k)) must be afforded to secured creditors as a matter of right—hinges on the resolution of competing interpretations of Section 1129(b)(2)(A).

Where a plan proposes to "cramdown" a secured creditor, forcing the secured creditor to accept a plan treatment to which it otherwise objects, Section 1129(b)(2)(A) becomes operative. This particular provision conditions the bankruptcy court's approval of "cramdown" plans on a judicial determination that the plan is "fair and equitable" to an objecting class of secured creditors. To determine whether a plan meets the "fair and equitable" standard, Section 1129(b)(2) states that "the condition that a plan be fair and equitable with respect to a class includes the following requirements: with respect to a class of secured claims, the plan provides (i) that the holders of the secured claims retain the liens securing the claims whether or not the debtor retains or transfers the property (the "Collateral Redemption Prong"); (ii) for the sale of any property subject to a lien that will give title to a buyer free and clear of the liens, that the sale be subject to Section 363(k) (requiring that a secured creditor be allowed to credit bid unless the court orders otherwise "for cause") (the "Sale Prong"); or (iii) that the holders of the claims realize the "indubitable equivalent" of their claim (the "Indubitable Equivalent Prong").

While the Sale Prong carries with it a presumptive right to credit bid in the event a secured creditor's collateral is sold free of its lien, the Indubitable Equivalent Prong is silent as to whether it applies to a sale. Additionally, whereas the Sale Prong, by invocation of Section 363(k), permits the secured creditor to bid the full face value of its claim, the inquiry as to whether a creditor received the indubitable equivalent of its claim arguably is limited in scope to the present economic value of the subject collateral.

The question presented on appeal in *Philadelphia Newspapers* to the Third Circuit was decided based upon the relationship in Section 1129(a)(2)(A) between clauses (ii) and (iii). Specifically, the Third Circuit was faced with choosing one of two competing interpretations of Section 1129(a)(2)(A): (1) whether the confirmability of a plan's treatment of a secured class is determined by first determining what type of plan it is and by then applying the statutory standard

applicable to that type of plan treatment (in other words, a plan providing for the retention of collateral would be evaluated under the Collateral Retention Prong of subsection (i), for the sale of collateral would be evaluated under the Sale Prong of subsection (ii), or a plan providing for the substitution of collateral under the Indubitable Equivalent proxy of subsection (iii)); or (2) whether the use of the disjunctive "or" between Sections 1129(b)(2)(A)(ii) and (iii) was intended to provide a plan proponent with an alternative method of plan confirmation, giving the plan proponent the option, for example, to seek confirmation of a plan based on a proposed sale of collateral under either the Sale Prong or the Indubitable Equivalent Prong and specifically allowing it to preclude credit bidding in the exact type of sale contemplated in subsection (ii)'s Sale Prong, so long as it nonetheless was able to satisfy the Indubitable Equivalent Prong of subsection (iii) with respect to the proposed sale.

In re Philadelphia Newspapers, LLC

THE TRAIL TO BANKRUPTCY

The Debtors, (collectively, Philadelphia Newspapers, LLC, along with a number of its affiliated entities) own and operate multiple print and online publications in the Philadelphia market, including the Philadelphia Inquirer (the third-oldest newspaper in the country), the Philadelphia Daily News, and the web site Philly.com. In 2006, a group of local Philadelphia investors purchased the related Debtor entities, which collectively employ nearly 4,600 individuals and engage approximately 9,000 independent contractors. The group invested nearly $150 million into the purchase, financing the remainder of the transaction by a $345 million credit facility provided by multiple Lenders. As collateral for the loan, the Lenders received first priority liens on, and security interests in, substantially all of the Debtors' real and personal property.

Throughout 2008, the Debtors encountered significant financial trouble, due to a loss of advertising revenue that they claim was a result of the recession, volatile credit market, and, particularly, lower automotive, real estate, and retail sales. Despite attempts to renegotiate the loans, the Debtors and their Lenders were unable to arrive at a mutually acceptable refinancing arrangement and the Debtors filed their respective Chapter 11 petitions on February 23, 2009. As of the filing of their voluntary petitions for Chapter 11 protection in February, 2009, the Debtors owed the Lenders nearly $297 million.

THE BANKRUPTCY CASE

The Plan

In August 2009, and within their period of exclusivity to propose a plan of reorganization, the Debtors filed a Joint Chapter 11 Plan that provided for the auction of substantially all of the Debtors' assets, with the exclusion of its headquarters building (valued at $30 million) which was to be directly surrendered to the Lenders. In conjunction with the Auction, the Debtors also executed an Asset Purchase Agreement with a Stalking Horse Bidder that was significantly comprised of several equity investors who were at one point insiders of the Debtors. The Plan contemplated a $30 million cash purchase price by the Stalking Horse, in addition to certain other payments and assumptions of liabilities that would, after administrative expenses, result in a distribution of $36 million to the Lenders. Most importantly, the explicit terms of the Debtors' proposed bid procedures for the auction assert that the sale is to be conducted pursuant to Sections 1123 and 1129 of the Bankruptcy Code, not Section 363. As a result, the Debtors' submitted auction bidding procedures that required that any bids on the assets to be sold must be submitted in cash, and affirmatively denied any holder of a lien to bid their credit toward the purchase of any assets. As rationale for precluding credit bidding, the Debtors claimed that the proposed procedures would encourage competitive bidding that otherwise would be chilled, given that the nearly $300 million that the Lenders could bid far exceeds the assets' fair market value.

The Lenders immediately objected to the proposed bidding procedures denial of credit bidding and argued that the approval of a "cramdown" liquidation Plan under Section 1129(b)(2)(A) mandates that secured parties be allowed to credit bid pursuant to the Sale Prong. Specifically, the Lenders pointed to

the interplay between Sections 1111, 1123, 1129 and 363 of the Code and asserted that they have a statutory right to credit bid in a public auction that is expressly granted by the Sale Prong and is also consistent with policy throughout the Code. The Debtors countered that Section 1129(b)(2)(A) provides three alternative methods for finding the "cramdown" plan "fair and equitable"—because they sought approval under the Indubitable Equivalent Prong and not the Sale Prong, there is no statutory requirement to permit credit bidding at the auction.

The Decisions Below

After hearing oral argument on the bid procedure issues, the bankruptcy court issued an Opinion and Order on October 8, 2009, denying the provisions that prohibited the Lenders from credit bidding at the auction. *In re Philadelphia Newspapers, LLC*, No. 09-11204, 2009 WL 3242292 (Bankr. E.D. Pa. Oct. 8, 2009). The bankruptcy court resolved the competing interpretations of Section 1129(b)(2)(A) in favor of the Lenders, holding that a secured creditor must be afforded the ability to credit bid the amount of its secured claim.

In examining the structure of Section 1129(b)(2)(A), the bankruptcy court found it to be latently ambiguous, holding that the use of a more general provision (the Indubitable Equivalent Prong) to achieve a result contemplated by a more specific provision (the Sale Prong) was at odds with statutory construction. Due to this ambiguity, the bankruptcy court resorted to the legislative history of the Bankruptcy Code, as well as secondary authority, and concluded that Congress intended to afford undersecured creditors the ability to protect their rights in collateral and, under the facts of the case, the Lenders were entitled to credit bid as a "matter of right."

The Debtors appealed the bankruptcy court's decision to the district court, acting as an intermediate appellate court, reversed the bankruptcy court's decision. *In re Philadelphia Newspapers, LLC*, 418 B.R. 548 (E.D. Pa. 2009). Specifically, the district court found that Section 1129(b)(2)(A) was unambiguous and the bankruptcy court erred in concluding that the Lenders had a statutory right to credit bid. The district court instead determined that the plain language of Section 1129(b)(2)(A) provides three distinct alternatives for satisfying the "fair and equitable" standard, stressing Congress' use of the disjunctive term "or" that separates each individual prong. Given such disjunctive language, the district court reasoned that Congress appears to have intended the provide three alternative paths to confirmation, one of which (the Indubitable Equivalent Prong) does not entitle a secured creditor the right to credit bid at a public auction. Thus, according to the district court, when plan confirmation is sought under the Indubitable Equivalent Prong, there is no guarantee that secured lenders have a right to bid their credit.[1]

As a result, the district court held that, standing alone, the Indubitable Equivalent Prong does not provide secured creditors a statutory right to credit bid. Following the decision, the Lenders immediately appealed to the Third Circuit, which granted an emergency stay of the auction pending oral argument on December 15, 2009.

THE APPELLATE OPINION

A little more than three months after oral argument, the panel, in a 2-1 rule, affirmed the district court's "alternate approach" interpretation of Section 1129(b)(2)(A). In a 49-page dissenting opinion, Judge Thomas Ambro alternatively interpreted Congress' use of the word "or" as modifying the application of Section 1129(a)(2)(A) to the type of plan, not to alternate methods for its confirmation—thereby requiring that any plan contemplating a sale of assets free of liens must preserve the secured lenders' right to credit bid to be confirmable.

The Majority Opinion

Purporting to apply strict application of the "plain meaning" canon of statutory construction, the majority interpreted the three prongs of Section 1129(b)(2)(A) to provide for three circumstances in which a plan could be "fair and equitable" to secured creditors. To arrive at this interpretation, the majority determined the "or" between the Sale Prong and Indubitable Equivalent Prong to mean that a debtor may proceed toward confirmation of a plan under any of the three

subsections and need not satisfy more than one. The majority also dismissed the Lenders' contentions that statutory construction requires that a that a plan proposing to sell assets free and clear of liens must comply with the specific provision rather than the general, holding that the inclusion of the Indubitable Equivalent Prong was evidence that Congress intentionally left open the potential for "other methods" of conducting asset sales, so long as the secure creditors' interests were protected and further discussed the similar holding of *In re Pacific Lumber*.

After having determined that Section 1129(b)(2)(A) provided for three distinct alternative routes to confirmation, the majority declined to find the Indubitable Equivalent Prong ambiguously broad and held, as a result, that the lenders may only assert a right to credit bid under that prong if the right is contained in the plain language of the statute—a right the majority was not willing to "read in" as a matter of law. Finally, the majority dismissed the lenders' assertions that other sections of the Bankruptcy Code (such as Section 1111(b)) that allow, and arguably protect, credit bidding should be read to inform the court's interpretation of Section 1129(b)(2)(A).

The majority was careful to make clear that the scope of the opinion was only limited to whether credit bidding must be afforded to secured creditors in a sale conducted pursuant to a "cramdown" Chapter 11 plan of confirmation as a matter of right. Because the bid procedures in question had not been implemented and the value to be realized at the sale was uncertain, the inquiry into whether precluding credit bidding would fail the Indubitable Equivalent Prong was a question of plan confirmation, and not one the court was in a position to conclude. Thus, the majority approved of the bid procedures in question, but noted that after the sale was complete, the Lenders could later object at the confirmation hearing that the absence of a credit bid did not provide it with the required "indubitable equivalent" of its collateral.

Judge Ambro's Dissent

Judge Thomas Ambro, a former Delaware bankruptcy attorney, in his dissent, interprets the statute to place different statutory requirements on confirmation depending on what the plan itself provides for treatment of the class of secured claims. Simply put, per this approach, the Sale Prong would exclusively apply if the plan provides for the sale of property free and clear of liens, subsection (i) would apply where the secured creditor retained the lien securing its claim, and the Indubitable Equivalent Prong would be operative in certain cases of abandonment of secured property or plans providing for substitute collateral.

The dissent explicitly acknowledges that both interpretations of Section 1129(b)(2)(A) are plausible readings of the statute. As support for his interpretation that all such sales must fall under 1129(b)(2)(A)(ii), he applies a number of canons of statutory construction to determine which interpretation is more plausible, reads Section 1129(a)(2)(A) in the context of other Bankruptcy Code provisions that protect credit bidding and secured creditors, and purports to rely on legislative history, arriving at relatively the same reasoning as the Bankruptcy Court did out the outset of the case.

However, Judge Ambro's dissent is not limited to a textual statutory analysis but includes a discussion of the possible impact of the majority's opinion on the expectations of secured lenders and the potential effects on the market for secured credit. In his dissent, he submits that the right to credit bid has been an important protection for secured creditors by acting both as a check on the integrity of the sale process itself by preventing the stalking horse purchaser (particularly one controlled or otherwise preferred by insiders or former insiders of the debtors) from acquiring the assets "'on the cheap'" and as an ultimate safety value for the secured lenders if, for whatever reason, the sale process is undervaluing collateral. Judge Ambro further submits that, as a result, secured lenders often have relied on their ability to credit bid when extending credit to debtors and have priced their loans in accordance with their bargain.

While acknowledging that there might be other ways that a secured creditor theoretically might protect itself from these risks (e.g., make a cash bid for the assets), Judge Ambro discounts that these other methods consistently will have the utility provided by the right to credit bid. Accordingly, in his view, the majority's decision likely will lessen the likelihood

that secured lenders will receive payment of the full value of their collateral and "uproots" at least 30 years' worth of "settled expectations" of secured lending.

Endnote

1 Citing to the Fifth Circuit's recent opinion in *In re Pacific Lumber*, the court found that it is entirely plausible that Congress envisioned a scenario where a debtor could conduct a collateral sale and assure that a secured creditor receive the benefit of its bargain without requiring that the plan provide the right to credit bid. 584 F.3d 229 (5th Cir. 2009) ("Whatever 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.").

For more information about the In re Philadelphia Newspapers, LLC *decision, or any other matter raised in this Client Update, please contact either of the following lawyers.*

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