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The Impact of *Philadelphia Newspapers* on Chapter 11 Asset Sales

On March 22, the United States Court of Appeals for the Third Circuit issued a decision that could significantly impact the rights of secured creditors to credit bid in connection with Chapter 11 asset sales under a plan of reorganization. It is unclear whether other circuits will adopt the Third Circuit's decision in *Philadelphia Newspapers, LLC*,[1] however, this decision has the potential of being a impediment for lenders and other funds that desire to take ownership of assets as a means to protect their collateral position, and for those funds and other creditors that seek to employ a "loan-to-own" strategy.

In sales governed by Section 363 of the Bankruptcy Code, a secured creditor generally has the option of bidding up to the full amount of its secured debt claim to acquire the assets to which its liens attach in exchange for a cancellation of indebtedness in the amount of the bid, a process known as "credit bidding."[2] While many believed that the same right was available in sales proposed in connection with plans of reorganization, the decision in *Philadelphia Newspapers* clarifies that such a right is not automatically available in all asset sales under Chapter 11, thereby allowing the debtor to determine whether credit bidding is allowed. The decision in *Philadelphia Newspapers* may significantly enhance the debtor's leverage, and this enhanced leverage may impair certain secured creditor protections and strategies.

The debtors in *Philadelphia Newspapers* filed a Chapter 11 plan of reorganization and proposed that their assets would be sold free and clear of all liens to a company operated by the debtors' chief executive officer and partially owned by an entity that held 30% of the equity of the debtors' parent company. The proposed sale would generate $37 million in cash for the secured creditors and the plan additionally proposed to distribute real estate valued at $29.5 million to the secured creditors. The debtors' plan prohibited credit bidding, thereby requiring the secured creditors that held approximately $300 million of debt to bid additional cash in order to acquire the assets. The creditors filed an objection to the plan that was upheld by the bankruptcy court. The debtors appealed the decision to the United States District Court for the Eastern District of Pennsylvania, which reversed the bankruptcy court's decision on the grounds that Section 1129(b)(2)(A)(iii) of the Code provides a means to sell the debtors' assets free and clear of liens without a legal entitlement to credit bidding. The Third Circuit's instant decision affirmed the District Court on substantially similar grounds.

The Third Circuit based its decision in the *Philadelphia Newspapers* case on the plain language of the Code, noting that while Section 1129(b)(2)(A)(ii) explicitly provides for an asset sale that is subject to credit bidding rights under Section 363(k), Section 1129(b)(2)(A)(iii) of the Code (which the debtors selected in this situation) does not refer to credit bidding and provides flexibility as long as the creditors receive the "indubitable equivalent" of their secured interests.[3] The Third Circuit determined that sub-clauses (i), (ii) and (iii) of Section 1129(b)(2)(A) of the Code are written in the disjunctive and, therefore, provide separate and distinct methods for creditors to receive compensation for collateral securing their liens. The Third Circuit also

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[1] *Citizens Bank of Pennsylvania v. Philadelphia Newspapers, LLC (In re Philadelphia Newspapers, LLC),* No. 09-4266 (3d Cir. Mar. 22, 2010). The Fifth Circuit Court of Appeals previously reached a similar decision in the Pacific Lumber bankruptcy case. *See Scotia Pacific Co., LLC v. Official Unsecured Creditors' Committee (In re Pacific Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009). However, because the *Philadelphia Newspapers* decision is binding precedent for the Delaware bankruptcy court in which a high percentage of corporate bankruptcies are filed, its impact promises to be far more substantial.

[2] Under Section 363(k) of the Code, a secured creditor is allowed to credit bid "unless the court for cause orders otherwise."

[3] *In re Philadelphia Newspapers, LLC, at 34.*

relied on the Fifth Circuit's recent decision in *Pacific Lumber*, which held that a secured creditor has no absolute right to credit bid when the collateral subject to its security interest is being sold under a Chapter 11 plan.[4]

While the Third Circuit held that secured creditors are not automatically entitled to credit bid in asset sales conducted pursuant to Section 1129(b)(2)(A)(iii) of the Code, the court specifically avoided addressing whether the proposed sale in question would result in the creditors receiving the "indubitable equivalent" of their secured interest in the collateral, and the court noted that the secured creditors retain the right to object to the debtors' Chapter 11 plan on that basis. Thus, on remand, the bankruptcy court may still decide not to confirm the debtors' Chapter 11 plan should it find, for example, that the proposed sale to insiders of the debtors in the absence of credit bidding cannot result in the secured creditors receiving the "indubitable equivalent" of their secured interests.[5]

Judge Ambro, a former bankruptcy attorney, dissented from the majority's opinion and argued that Section 1129(b)(2)(A)(ii), with its overt credit bidding right, should exclusively govern where sales of assets free of liens are proposed under Chapter 11 plans, with Section 1129(b)(2)(A)(iii) controlling only in situations not explicitly contemplated by Section 1129(b)(2)(A)(i) or Section 1129(b)(2)(A)(ii) of the Code. The dissent further stated that merely providing a creditor the "indubitable equivalent" of the value of its collateral is contrary to the expectations of parties negotiating secured financing transactions and effectively results in secured creditors being less likely to receive the full value of their bargained-for collateral. Denying secured creditors the ability to credit bid under Section 1129(b)(2)(A)(ii) would, in the dissent's view, adversely affect the ability of lenders to receive sufficient value or utility for their collateral.

There will likely be several consequences of the Third Circuit's decision that secured creditors do not always have the right to credit bid. Most importantly, lenders and other secured creditors will need to realize the potential liquidity requirements and risks that may be imposed on them in connection with proposed asset sales under a Chapter 11 plan of reorganization. To the extent a plan provides for such sales without the right to credit bid, the secured creditor may be required to bid cash to obtain the assets. However, we would note that, pursuant to the absolute priority rule codified in Section 1129(b) of the Bankruptcy Code, those cash proceeds bid and paid by the secured creditor should generally, in turn, be repaid to the secured creditor as proceeds of its collateral. (The right to credit bid can be understood largely as an administrative mechanic to avoid the need to "round trip" cash in connection with the sale of collateral.) There are certain practical constraints on the ability of the secured creditor to simply "round trip" the proposed cash purchase price, including the risk of certain post-sale challenges to the secured claim and the need to reach agreement with other lenders and creditors secured by the same lien with respect to the return of bid proceeds.

In addition, the Chapter 11 process may be delayed because courts will be faced with actions by secured lenders to protect their position, which may include the need to condition any provision of post-petition financing (or consent to the use of cash collateral) on maintenance of the right to credit bid, to commence litigation to terminate exclusivity to propose a competing plan of reorganization which provides for credit bidding, and to object to plan confirmation based on disputes with respect to collateral valuation and the uncertainty and vagueness of the "indubitable equivalent" standard.

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[4] *In re Pacific Lumber Co., 584 F.3d at 245-49.*

[5] In the *Pacific Lumber* case, the Fifth Circuit found that a cash payment to the secured creditors from the sale proceeds was the indubitable equivalent of their interest in the collateral. However, the case did not involve an auction and the court determined the value of the collateral based on extensive expert testimony. 584 F.3d at 247-48.

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