SECURED LENDERS' RIGHTS TO CREDIT BID: INDUBITABLY NOT

March 31, 2010

To Our Clients and Friends:

On March 22, 2010, in a split decision, the United States Court of Appeals for the Third Circuit ruled that secured creditors do not have a statutory right to credit bid when their collateral is sold pursuant to a plan of reorganization and the plan is confirmed under the "cramdown" provisions of the Bankruptcy Code. The much anticipated decision in *In re Philadelphia Newspapers, LLC* holds that a plan of reorganization that prohibits credit bidding may be confirmed under Section 1129(b)(2)(A)(iii) of the Bankruptcy Code so long as it provides secured creditors with the "indubitable equivalent" of their secured claims.

While last year the United States Court of Appeals for the Fifth Circuit reached a similar conclusion in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009), the facts presented in that case were unusual in several respects. In addition, the Third Circuit includes the District of Delaware, a popular venue for large, complex Chapter 11 cases. Consequently, the *Philadelphia Newspapers* ruling may have an impact on many pending and future bankruptcy proceedings.

BACKGROUND

Philadelphia Newspapers, LLC and its affiliates filed voluntary bankruptcy petitions on February 22, 2009. Prior to the bankruptcy filing, in 2006, an investor group acquired the *Philadelphia Inquirer* and *Philadelphia Daily News* for approximately $515 million. The purchase price was funded in part by the proceeds of a $295 million syndicated loan secured by a first priority lien on substantially all of the debtors' assets.

In August 2009, the debtors filed a plan of reorganization which provided that their assets (other than certain real estate) would be sold at a public auction free and clear of liens, including the liens securing the syndicated loan. Contemporaneously, the debtors entered into a "stalking horse" asset purchase agreement with a company controlled by certain existing stockholders of the debtors. The proposed sale to insiders would generate approximately $37 million which would be paid directly to the secured lenders. In addition, the secured lenders would acquire the newspaper's headquarters valued at $29 million (subject, however, to a two-year, rent-free lease to the purchaser).

The bidding procedures proposed by the debtors in connection with the sale required that all bids be in cash and precluded the secured lenders from credit bidding their loans at the auction. The debtors contended that credit bidding would discourage higher and better offers. The secured lenders objected, arguing that the prohibition on credit bidding violated the "fair and equitable" standard set forth in the "cramdown" provisions of the Bankruptcy Code.

BANKRUPTCY CODE

Under Section 1129(b) of the Bankruptcy Code, a plan of reorganization may be "crammed down," or confirmed without the consent of an impaired class of creditors or interest holders, if the plan does not "discriminate unfairly" and is "fair and equitable" with respect to such class. A plan is fair and equitable with respect to a class of secured claims, if the plan provides one of three things: (i) that the secured creditors retain their liens and receive deferred cash payments of a specified amount and value, (ii) for the sale of the assets securing the claims free and clear of the secured creditors' liens but with the liens attaching to the proceeds of the sale and the secured creditors retaining the right to credit bid in connection with the sale pursuant to Section 365(k) of the Bankruptcy Code or (iii) that the secured creditors receive the "indubitable equivalent" of their secured claims.

DECISION

Relying on the "plain meaning" of the relevant statutory provisions, a majority of the Third Circuit panel held that the three prongs of Section 1129(b)(2)(A) represent alternative means of complying with the "fair and equitable" standard and that secured creditors do not have the right to credit bid their secured claims when assets are sold pursuant to a plan of reorganization which provides the secured creditors with the indubitable equivalent of their secured claims. In so holding, the majority decision rejected the secured lenders' arguments that (i) a sale of collateral pursuant to a plan of reorganization must comply with Section 1129(b)(2)(A)(ii), including the right to credit bid and (ii) in order to provide secured creditors' with the indubitable equivalent, a plan must as a matter of law permit secured creditors to credit bid.

In dictum which may attract as much attention as the principal holding, the majority of the panel also argued that a court's right under Section 363(k) to prohibit credit bidding "for cause" was not limited to situations in which the secured claims and liens were the subject of dispute and might be invoked where a court concluded that credit bidding could chill competitive bidding in connection with a sale.

In a lengthy dissent, Judge Ambro, a prominent member of the Delaware bankruptcy bar prior to his appointment to the Third Circuit, argued that the majority decision was inconsistent with both the broader statutory scheme reflected in the Bankruptcy Code and relevant legislative history. Judge Ambro also warned that credit bidding represents an important check on the ability of plan proponents to undervalue collateral and that a sale process in which credit bidding is prohibited is subject to manipulation. Judge Ambro argued that the record before the court contained evidence of such abuse, including an advertising campaign by the debtor urging that ownership of the newspapers be kept local.

Please feel free to contact us with any questions.

Richard F. Hahn
+1 212 909 6235
rfhahn@debevoise.com

Joan M. Stout
+1 212 909 6357
jmstout@debevoise.com

Steven R. Gross
+1 212 909 6586
srgross@debevoise.com

Michael E. Wiles
+1 212 909 6653
mewiles@debevoise.com

George E.B. Maguire
+1 212 909 6072
gebmaguire@debevoise.com

My Chi To
+1 212 909 7425
mcto@debevoise.com

Jasmine Ball
+1 212 909 6845
jball@debevoise.com