Philadelphia Newspapers: The Unanswered Questions for Secured Creditors

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Many lenders have been taken by surprise by some debtors' recent frontal assault upon "credit bidding" in bankruptcy sales under plans of reorganization, a right that secured creditors regarded as sacrosanct. Lenders are understandably worried that the recent Third Circuit decision in *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. Pa. 2010) ("*Philly News*"), will dramatically shift bargaining leverage in the direction of debtors and other interested parties in chapter 11 cases. This perceived power shift is not a problem easily remedied by better documentation or other pre-bankruptcy fixes. Instead, it will likely result in far more aggressive litigation early in cases. Eventually, the pendulum will likely come to rest not terribly far from the pre-*Philly News* leverage balance.

The reason for a likely litigation surge is simple. The Third Circuit left open the critical, bottom line question: exactly when can a sale under a plan be approved if lenders are not allowed to credit bid? Remand to the *Philly News* bankruptcy court yielded one answer: the plan can be confirmed if the secured creditors win the contested auction sale without credit bidding and therefore do not object to the proposed plan of reorganization. This outcome was just blessed by the bankruptcy court in approving the sale to the lenders as part of the plan confirmed on June 28, 2010.

But what if the lenders had lost at the auction or objected to confirmation on the grounds that the sale process was defective or unfair? According to the Third Circuit, the plan must pass muster under the *indubitable equivalent* standard. Meeting this standard for a plan sale without credit bidding will not be a slam dunk for debtors.

This article: (1) briefly summarizes what the Third Circuit held - and declined to hold - in *Philly News*; (2) examines the course of events in the chapter 11 proceedings since the decision; and (3) analyzes the impact of the decision on future insolvencies and the dynamic between debtors and secured lenders.

I. In re Philadelphia Newspapers - The Third Circuit Decision

Fundamentally, the *Philly News* parties were arguing about the statutory requirements for "cramming down" secured creditors under a plan. Bankruptcy Code

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§ 1129(B)(2)(A) provides for three ways in which a debtor can confirm a plan of reorganization over the objection of a secured creditor: (i) by allowing the lender to retain its lien on the same collateral; (ii) by selling the collateral with the lender having the right to credit bid at the sale under the plan; or (iii) by providing the secured creditor with the "indubitable equivalent" of its claim. The debtors in *Philly News* proposed a sale of the Philadelphia Inquirer newspaper and substantially all of the rest of their businesses under the terms of a sale that did not allow for credit bidding by the secured creditors. Equity holders, together with former management, wanted to make a bid; other third parties were also interested.

The proposed sale under the plan did not, on its face, satisfy either of the first two cram down alternatives. Because the sale was to be free and clear of the liens, alternative (i) was not satisfied. Similarly, because the secured creditors were not allowed to credit bid at the sale, alternative (ii) was not satisfied. In ruling upon a motion to approve procedures for a sale of the business, the bankruptcy court held that the sale could not proceed without credit bidding. The district court reversed.

The issue posed to the Third Circuit was whether a sale under the plan must allow for credit bidding under alternative (ii), where the issue of whether the plan satisfied alternative (iii) had not yet been decided by the bankruptcy court because the confirmation hearing had not yet been held. To the surprise of many, the circuit court agreed with the debtors, saying that the first two prongs of § 1129(b)(2) were merely "examples" that Congress provided for debtors to satisfy the fair and equitable requirement, and they were not meant to limit a debtor's ability to use any method available that provides the "indubitable equivalent."[1] The Third Circuit thus held that secured lenders do not have an automatic right to credit bid in a sale of their collateral pursuant to a plan of reorganization. This interpretation of § 1129(b)(2)(A) upended conventional wisdom. As Judge Ambro's dissent observed, "[a]lthough few in the first 30 years of Bankruptcy Code jurisprudence read it that way, the majority [held] that 11 U.S.C. §1129(b)(2)(A)(ii) is not the exclusive method through which a debtor can cram down a plan calling for the sale of collateral free of liens."[2]

Importantly though, the court left open the key question of whether the sale of assets pursuant to a plan without permitting credit bidding can meet that indubitable equivalent standard. The problem for secured creditors facing this precedent is that the question has been entirely derailed on remand and will never be answered in this case.

II. Philly News Since the Third Circuit Ruling

a. The Auction

Upon remand, the Bankruptcy Court for the Eastern District of Pennsylvania approved the bid procedures at issue, which explicitly prohibited credit bidding. Instead of backing down, many but not all of the secured lenders formed a consortium and assembled a cash bid for the assets of the troubled newspaper company.[3] The other two bidders were: (1) a combination of the former stalking horse bidder (the former equity holders of the debtors) and financially supported by the Perelman family; and (2) the so-called "Stern Group" of bidders. Since there was

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more than one qualified bid, an auction was held on April 27, 2010 at the offices of Proskauer Rose in New York.

At the auction, the secured lender group outbid the local equity holders, with a bid of $105 million. Under the terms of the sale, the secured creditor/buyers must post the cash required for the sale upon confirmation, to be used to fund the plan. Since not all pre-petition secured lenders are participating in the purchase of the debtors' assets, the cash is not making a pure "round-trip" back to the buyers, although, of course, the consortium will share in the plan distributions to the extent that they are pre-petition secured lenders.

b. The Plan

As the Third Circuit Court noted, even in accordance with its decision, "a lender can still object to plan confirmation on a variety of bases, including that the absence of a credit bid did not provide it with the 'indubitable equivalent' of its collateral."[4] However, as the winners of the auction, the secured creditors did not object to confirmation of the sale and the plan. No one else challenged the sale either. Accordingly, on June 28, 2010, the bankruptcy court approved the successful bid at the confirmation hearing, and the plan was confirmed.

The plan provides for the secured lenders to receive: (1) $86 million; and (2) title to the debtors' headquarters, located in downtown Philadelphia, purportedly worth $29 million. The debtors estimate the secured lenders' recovery to be 36 percent. According to the disclosure statement, the cash remaining from the purchase price, as well as over $3 million that the debtors expect to have on hand, will be used to pay administrative claims in full, pay mezzanine lenders 1.5 percent of their claims, and pay the rest of the general unsecured creditors between 1 percent and 23 percent, depending on the allowed amount of certain claims. Payments are to be made on the effective date of the plan, assuming that no appeal is taken (and, based upon the nature of the plan objections, none is likely).

c. The Unanswered Questions

Let's consider the situation in a *Philly News* type of auction (Example A), where disgruntled secured creditors are not able to assemble the funds from which to make their own cash bid, and some other bidder wins the sale auction for $50 million instead of the $100+ million that the lenders believe to be the fair market value of the collateral. Another possible scenario would be a plan that proposes to: (1) start selling individual condominium units in a building that is subject to a $100 million construction loan that bars unit sales; (2) retain a percentage of the proceeds for further marketing and operating expenses; and (3) pay the balance of each sale's proceeds to the secured lender – but without allowing the secured creditor to credit bid because obviously any credit bid would exceed individual unit prices (Example B). In fact, just this kind of plan was proposed in the *Meruelo Maddux Properties, Inc.* chapter 11 cases ("*MMPI*") in Los Angeles, in which the judge ruled, in an unreported decision in the context of a contested sale motion and parallel relief from the stay motion, that the proposed plan was unconfirmable under the indubitable equivalent standard.

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The Third Circuit ruling allows for secured creditors to object to confirmation on the grounds that the plan failed to provide them with the "indubitable equivalent" of their claim, which was defined by the *Philly News* court as the "unquestionable value of a lender's secured interest in the collateral." A lender's secured interest is, in turn, "the extent of the value of such creditor's interest in the estate's interest in such property."[5] Thus, "indubitable equivalent" is generally considered to mean that no party receives an ounce of value from the collateral until the secured lender receives its full payment.[6]

Presumably, under such circumstances, the secured creditors in both examples will want to object to the plan as failing to satisfy the indubitable equivalent standard. What grounds for objection are available?

<u>Objections based upon the bid and sale procedures</u> - In *Philly News*, the credit bid rights issue arose in connection with the debtors' motion to approve bid procedures. However, the indubitable equivalent issue was apparently not raised – or at least, not decided – in connection with that motion. The Third Circuit left the door open for an indubitable equivalent challenge to the sale under the plan, which theoretically would permit the secured creditors to have a second chance to attack the bid procedures. However, most if not all, bid procedures objections would necessarily have already been made and would not likely be entertained again by the bankruptcy court for the purpose of applying the indubitable equivalent standard, including such objections addressing the amount or terms of any breakup fee (and whether it was so high as to chill bidding), the sufficiency of the marketing, the appropriate amount of any good faith deposit, and the adequacy and fairness of bidders' access to diligence information. Although the right to credit bid is obviously ripe for ruling on the procedures motion, none of the other bid procedures issues bear upon the secured creditor's treatment under the plan, which is the heart of the indubitable equivalent issue.

<u>Objections based upon valuation</u> - Once an auction has occurred, it is likely to be regarded as substantial evidence of the current value of the collateral, particularly if overbidding by competing bidders has occurred. The secured creditors could certainly offer appraisal evidence to show that the price is below comparable sales, but a distressed, hurried auction constitutes something more akin to a fire sale than a regular arm's length sale, so the price realized at such an auction could be expected to come in lower than appraisals. A 50 percent discrepancy such as Example A's might be enough to raise issues, but secured creditors are not entitled to the potential upside value of the collateral – instead, they are entitled to only the current value. However, the post hoc effect of the sale result places a premium upon asserting confirmability objections at the disclosure hearing stage of the case, before the sale occurs. It might be possible to argue that the appraisal evidence is strong enough to support the imposition of a reserve price, even though a credit bid is not permitted.

In Example B, the sale of the first individual condo would typically trigger obligations to create reserves for the homeowners association, new home warranties, and other similar obligations that would require use of the secured creditor's cash collateral. Moreover, the secured creditor would be at risk that not enough units would sell to repay the loan. The secured creditor would no longer hold a unitary lien on the whole building, nor would it be able to foreclose on the entire building. These kinds of fundamental alterations of the risk profile persuaded the *MMPI* court to refuse to

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approve the sale based upon a determination that the indubitable equivalent standard has not been satisfied. *See, e.g.*, *In re Arnold & Baker Farms*, 85 F.3d 1415, 1422 (9th Cir. 1996) (prohibiting lien stripping and "dirt for debt" plans); *In re Sparks*, 171 B.R. 860, 866 (Bankr. N.D. Ill. 1994).

The possibility of a sale meeting the indubitable equivalent standard is not illusory, however. Some sales would qualify, for example if the debtor can demonstrate that the value of the collateral far exceeds the secured debt. Sale of one of two pieces of collateral without credit bidding could well be authorized if the remaining collateral is worth two or three times the debt. Such circumstances tend to be rare.

Objections based upon the absolute priority rule - For a plan to be confirmable, it must comply with the absolute priority rule, which states that a class of creditors may not receive any recovery until all senior classes of creditors are paid in full. In *Philly News*, the plan provides for junior unsecured creditors to receive a distribution under the plan – perhaps even as much as 23 percent, while the senior secured creditors' recovery is capped at 36 percent. Generally, a plan providing for such distributions to junior classes would run afoul of the absolute priority rule and not be confirmed. In Example B, a plan that provided for payment to junior classes was determined in *MMPI* to be unconfirmable because it also would fail to provide for "the unquestionable value" of the secured creditors' interest in the collateral by giving part of that value to the unsecured creditors.

This issue goes to the heart of the matter: as a practical matter, only two reasonable explanations could justify plan sales without credit bids. One reason would be to bring cash into the estate that could be distributed to other creditors, whereas credit bids do not normally yield any distributable cash other than a small amount for administrative surcharges. Such distributions, however, would thereby transfer some of the value of the collateral to other classes of creditors, including administrative claims that could not be surcharged to the collateral, as well as priority and unsecured creditors. This kind of objective runs into the absolute priority wall.

A second possible justification could simply be to try to prevent the secured creditor from bidding at all, on the theory that it would not have the resources to raise the cash to bid. Large consortiums of lenders may have trouble raising cash and obtaining the required approvals from all parties required to sign off on a deal. This is particularly true when those parties have sunk so much money into a troubled company already. Barring credit bidding could thus be in service of some other bidder that is favored for extrinsic reasons, for example, as appears to have been the case in *Philly News*, where debtors were trying to keep their newspaper in the hands of local owners and out of the hands of "foreign" financial institutions. But measures that suppress effective bidding (in the sense of disqualifying the secured creditors) could be viewed as transferring part of the collateral value to the lucky third party bidder with respect to the indubitable equivalent standard. In the end, it is hard to say that lenders are receiving the indubitable equivalent of their collateral when they are forced to pay for it a second time in order to foreclose on it.

III. Impact of Philly News

Creating an opportunity to fight about indubitable equivalence inherently gives more leverage to debtors than an interpretation mandating credit bidding for all sales

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under plans. Loan-to-own creditors, who purchase claims intending to take control of the collateral, may be particularly affected by this ruling. To take advantage of this ruling, debtors have to survive in chapter 11 long enough to confirm plans with sales that bar credit bidding, as credit bidding will still be the standard in sales under Bankruptcy Code § 363. The result is likely to be a shift in battles for leverage at the outset of the case. Secured creditors who are also acting as DIP lenders are likely to bargain for the right to credit bid as a condition of the DIP loan. Early relief from stay motions contending that no plan is confirmable under the indubitable equivalent standard may become far more frequent.

Philly News illustrates both the importance and frustration of interlocutory appeals in bankruptcy cases. The debtors were able to obtain a reversal, which changed the facts on the ground. On the other hand, the partial ruling effectively precluded a final determination of the question of when the indubitable equivalent standard can be satisfied. These secured creditors ultimately decided to buy their way out of the box created by the debtors. The one safe bet from the *Philly News* case: indubitable equivalence will be argued early and often by undersecured creditors.

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[1] *Philly News*, 599 F.3d at 310.

[2] *Philly News*, 599 F.3d at 319.

[3] According to the Second Supplement to First Amended Disclosure Statement With Respect to the First Amended Joint Chapter 11 Plan as of October 27, 2009 (as Amended by the Second Amended Joint Chapter 11 Plan as of May 19, 2010), "[t]he Purchaser has received commitments for debt and equity financing from certain holders of Prepetition Senior Secured Claims. The Purchaser received equity commitments from: Alden Global Distressed Opportunities Fund, L.P.; Credit Suisse Securities (USA) LLC; Venor Capital Management Master Fund, Ltd.; and Halbis Distressed Opportunities Master Fund Ltd. The Purchaser received debt commitments from: Bank of Utah, as Exit Agent; and the following Initial Lenders, Angelo Gordon & Co., L.P., on behalf of certain managed funds and accounts; Credit Suisse Loan Funding LLC; Alden Global Distressed Opportunities Fund, L.P.; McDonnell Loan Opportunity Ltd.; Gannet Peak CLO I, Ltd.; Wind River CLO II; Tate Investors, Ltd.; Wind River CLO I Ltd.; Halbis Distressed Opportunities Master Fund Ltd.; Pacifica CDO V, Ltd.; Pacifica CDO VI, Ltd.; PMT Credit Opportunities Fund Ltd.; and Cerberus Partners, L.P."

[4] *Philly News*, 599 F.3d at 317–18.

[5] *Philly News*, 599 F.3d at 310.

[6] One exception: the collateral might be subject to a surcharge under § 506(c) of the Bankruptcy Code for "the reasonable, necessary costs and expenses of preserving, or disposing of" property securing the claim.

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