KIRKLAND & ELLIS LLP

KIRKLAND ALERT

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District Court Limits the Right to Credit Bid in Asset Sale Conducted Under Chapter 11 Plan

Introduction

As highlighted by the General Motors and Chrysler bankruptcy cases, companies experiencing financial distress may use the bankruptcy process to sell their assets "free and clear" of liens pursuant to section 363 of the Bankruptcy Code and pay the net sale proceeds over to their secured creditors. Section 363 also protects secured creditors whose collateral is being sold by enabling secured creditors to "credit bid" their claims at a section 363 sale to protect against a sale at what the creditors perceive is a below-market price.

Nonetheless, the District Court for the Eastern District of Pennsylvania, in *In re Philadelphia Newspapers, LLC,* 2009 WL 3756362 (E.D. Pa. Nov. 10, 2009), recently ruled that debtors can preclude credit bids in asset sales conducted pursuant to a chapter 11 plan (not pursuant to section 363), where secured creditors receive the "indubitable equivalent" of their claims. If followed widely, the *Philadelphia Newspapers* decision may limit the ability of secured creditors to use secured debt as currency to purchase a debtor's assets, or to block an asset sale, under a plan for less than the secured debt.

Philadelphia Newspapers Decision

Philadelphia Newspapers, LLC and its affiliates (collectively, the "Debtor") own and operate numerous print and online publications in the Philadelphia region, including the *Philadelphia Inquirer* and the *Philadelphia Daily News*. In June 2006, an investor group had purchased the Debtor's principal business divisions from the McClatchy Company, a media conglomerate, financed by an approximately $295 million loan secured by first priority liens on substantially all of the Debtor's assets.

In February 2009, the Debtor commenced chapter 11 cases due to, among other things, a declining advertising revenue base. By August 2009, the Debtor proposed a chapter 11 plan contemplating a sale of substantially all of the Debtor's assets to certain equity investors willing to act as a stalking horse bidder, subject to higher and better bids at a public auction. The stalking horse's bid called for the purchase of the Debtor's assets for $30 million in cash and the assumption of approximately $41 million of the Debtor's liabilities. Notably, the Debtor's sale was a sale of assets not pursuant to section 363 of the Bankruptcy Code, which enables a debtor to sell its assets outside the context of a chapter 11 plan. Instead the sale was pursuant to section 1123 of the Bankruptcy Code, which enables a debtor to sell its assets and distribute the sale proceeds pursuant to a chapter 11 plan of reorganization.

Shortly after filing the chapter 11 plan, but well before the confirmation hearing, the Debtor sought bankruptcy court approval of bid procedures for the public auction. The Debtor's secured lenders objected, in part, because the procedures prohibited credit bidding. The lenders argued that (1) they would object to the plan, requiring the Debtor to "cram down" the plan over the lender's objection under section 1129(b) of the Bankruptcy Code and (2) section 1129(b)(2) specifically preserves the lenders' right to credit bid at a sale conducted under a chapter 11 plan. Thus, the lenders contended, the Debtor could not ultimately cram down and con-

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firm the chapter 11 plan over the lenders' objection unless the bid procedures provided the lenders with the right to credit bid.

The Debtor asserted that section 1129(b)(2) provides three alternative methods to "cram down" a plan over the secured lenders' objections, and only one alternative preserves a lender's right to credit bid. Specifically, under section 1129(b)(2), for a plan to be confirmed over the objections of secured creditors, the plan must provide that the secured creditors: (1) retain their liens and receive deferred cash payment of their secured claims; (2) retain the right to credit bid at any sale of lender collateral; or (3) receive the "indubitable equivalent" of their secured claims.[1] The Debtor claimed it would be able to comply with the third alternative by providing the secured lenders with the "indubitable equivalent" of their claims by paying the sale proceeds to the secured lenders.

The bankruptcy court refused to approve the Debtors' bid procedures, holding that section 1129(b)(2) does not permit a debtor to preclude credit bidding by proposing to provide secured lenders with the indubitable equivalent of its claims in any chapter 11 plan sale. On appeal, however, the district court reversed the bankruptcy court's decision. The district court found that because the three alternatives in section 1129(b)(2) are stated in the disjunctive, a debtor need only satisfy one alternative to the exclusion of the others.[2] In reaching its decision, the district court cited the opinion of the Fifth Circuit Court of Appeals in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. Sept. 29, 2009), providing that secured creditors did not have the right to credit bid under section 1129(b)(2) where they were receiving the indubitable equivalent of their secured claims in a private judicial sale.[3] Finding that section 1129(b)(2) did not distinguish between private and public sales, the district court held that as long as the Debtor provides its secured creditors with the indubitable equivalent of their secured claims, it could prohibit secured creditors from credit bidding their claims in any chapter 11 plan sale.[4]

The secured lenders have appealed the district court's decision to the Third Circuit Court of Appeals, which has scheduled oral arguments for December 15, 2009. The auction has been stayed pending the appeal.

Potential Effects on Future Bankruptcy Sales

The *Philadelphia Newspapers* decision leaves several questions unanswered. For example, the opinion does not address what form of sale proceeds (*e.g.*, cash, equity or some other currency) will constitute the indubitable equivalent of secured claims. Further, the court left open the question of how far in advance of a plan a debtor can conduct an auction to sell assets and still qualify that sale as being under a plan (and thus seek to prohibit credit bidding). In any event, the *Philadelphia Newspapers* decision, if upheld on appeal and broadly followed, would provide debtors with an opportunity to preclude credit bidding at sales conducted pursuant to chapter 11 plans. It is possible that in certain situations, particularly when a contemplated sale may not generate sale proceeds exceeding the secured debt, a debtor may decide to structure an asset sale through a chapter 11 plan to avoid competing credit bids in an attempt to preclude the under-secured creditor from blocking the sale.

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1 *See* 11 U.S.C. § 1129(b)(2)(A).

2 *See In re Philadelphia Newspapers, LLC,* 2009 WL 3756362, at *14 (E.D. Pa. Nov. 10, 2009).

3 *See In re Pacific Lumber Co.,* 584 F.3d 229, 245-46 (5th Cir. Sept. 29, 2009).

4 *See Philadelphia Newspapers,* 2009 WL 3756362, at *15. Notably, the district court did not address whether the proposed purchase price constituted the indubitable equivalent of the secured lenders' secured claims.

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