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Feature

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Credit-Bidding in "Free and Clear" Sale Upheld by Supreme Court

In an 8-0 decision[2] on May 29, 2012, the U.S. Supreme Court in *RadLAX Gateway Hotel LLC v. Amalgamated Bank*[3] unequivocally held that a reorganization plan that proposes to sell a secured creditor's collateral free and clear of liens must permit the secured creditor to credit-bid its claim absent "cause" to deny it the right to do so. The Court's decision provides the final word on the contours of credit-bidding in bankruptcy. In affirming the Seventh Circuit's June 28, 2011, ruling in *River Road Hotel Partners LLC v. Amalgamated Bank*,[4] the decision overrules a contrary opinion of the U.S. Court of Appeals for the Third Circuit in *In re Philadelphia Newspapers LLC*.[5] The effect of the decision is to close *Philadelphia Newspapers*' loophole in the ring of statutory protections for the secured creditor's historic right to "get its money or its collateral." Debtors will not be able to use free-and-clear plan sales to shift value from a secured creditor to other interests without the secured creditor's consent.

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Statutory Framework

The requirements for confirmation of a chapter 11 plan appear in § 1129 of the Bankruptcy Code.[6] Normally, § 1129(a)(8) requires that all impaired classes vote in favor of the plan.[7] However, § 1129(b)(1) provides that a plan may be confirmed over the objections of an impaired class if, among other things, the plan is "fair and equitable" to that class. The plan proponent (typically the debtor-in-possession) has the burden of proof on this issue. Section 1129(b)(2)(A) provides three alternative circumstances, enumerated in three separate subsections, that a plan must satisfy at a minimum to be "fair and equitable" to a dissenting class of secured creditors:[8]

- under subsection (i), retention by the secured creditors of their liens and the receipt of deferred cash payments totaling at least the allowed amount of their claims with a value at least equal to the present value of the secured creditors' interest in their collateral;
- under subsection (ii), a sale of the assets free and clear of the secured creditors' liens, provided that the secured creditors are furnished the right to credit-bid their claims in accordance with § 363(k), with the liens to attach to the proceeds of sale; or
- under subsection (iii), the realization by the secured creditors of the "indubitable equivalent" of their claims.

Section 363(k), which subsection (ii) imports, allows a secured creditor that bids on a sale of its collateral under § 363(b) to offset, as against its bid, up to the full amount of its claim, although the bankruptcy court can condition the right to credit-bid if "cause" to do so is shown.

1 The authors successfully represented Amalgamated Bank, the secured creditor, in this case, with Ms. Maynard presenting oral argument before the Supreme Court.
2 Justice Kennedy recused himself from the case.
3 *RadLAX Gateway Hotel LLC v. Amalgamated Bank*, No. 11-166, 2012 U.S. LEXIS 3944 (May 29, 2012) (*RadLAX*).
4 *River Rd. Hotel Partners LLC v. Amalgamated Bank (In re River Rd. Hotel Partners LLC)*, 651 F.3d 642 (7th Cir. 2011) (*River Road*). *River Road* addressed two related bankruptcy cases pending in the U.S. Bankruptcy Court for the Northern District of Illinois: *In re River Road Hotel Partners LLC*, Case No. 09-30029, and *In re RadLAX Gateway Hotel LLC*, Case No. 09-30047. The two proceedings were separately administered; however, because the hotels (and their related properties) that were the primary assets in each case shared common management and ownership, the cases were generally conducted in parallel and each raised the identical issue in the Seventh Circuit appeal.
5 *In re Phila. Newspapers LLC*, 599 F.3d 298, 318 (3d Cir. 2010).
6 The "Bankruptcy Code" is 11 U.S.C. §§ 101-1532. Hereinafter, unless otherwise specified, all statutory references are to the Bankruptcy Code.
7 Essentially, a class is impaired if the plan modifies the class's rights in any way (even if apparently favorably).
8 Though not an issue in *RadLAX*, a plan can satisfy one of these standards but not be fair and equitable; they are necessary, but not necessarily sufficient, conditions for such a cramdown (*e.g., Fed. Savs. & Loan Ins. Corp. v. D & F Constr. Inc. (In re D & F Constr. Inc.)*, 865 F.2d 673, 675 (5th Cir. 1989); *In re Riddle*, 444 B.R. 681, 686 (Bankr. N.D. Ga. 2011); *In re Atlanta S. Bus. Park Ltd.*, 173 B.R. 444, 448 (Bankr. N.D. Ga. 1994)).

The Credit-Bidding Landscape before *RadLAX*

In March 2010, the Third Circuit Court of Appeals issued its much-publicized *In re Philadelphia Newspapers LLC* decision by a 2-to-1 majority.[9] In this case, the Third Circuit ruled that a reorganization plan that provides for a sale of assets free and clear of liens does not have to permit the secured creditors the right to credit-bid as specified in § 1129(b)(2)(A)(ii). Rather, in a departure from the long-held conventional view, the Third Circuit found that a reorganization plan can satisfy the requirement that the plan be fair and equitable to a secured creditor by providing the secured creditor with the "indubitable equivalent" of its claim under § 1129(b)(2)(A)(iii) in the form of the sale proceeds and/or other compensation.[10]

RadLAX: Bankruptcy Court Decision

In the fall of 2009, the River Road debtors and the RadLAX debtors filed for voluntary chapter 11 petitions in the U.S. Bankruptcy Court for the Northern District of Illinois. Each set of debtors owned a hotel and related assets. At the time that the petitions were filed, the RadLAX debtors owed their lenders, represented by Amalgamated Bank as agent, more than $130 million secured by a blanket lien on their assets, and the River Road debtors owed the same lenders, also agented by Amalgamated, more than $160 million secured by the River Road debtors' assets. These loans were underwritten and made essentially at the peak of the recent economic bubble. However, by the time the cases were filed, the bubble had burst. In the case of both sets of loans, the value of the collateral was well short of the claims it secured, and as a result, the estates were vastly underwater.

In mid-2010, the RadLAX and River Road debtors filed reorganization plans modeled largely on the plan at issue in *Philadelphia Newspapers*. The plans provided for the sale of the assets free and clear of liens at an auction at which the lenders would be denied the right to credit-bid outright (or for "cause" if the bankruptcy court disagreed with *Philadelphia Newspapers*). The bankruptcy court would then assess whether the winning bid provided the lenders with the indubitable equivalent of their claims under § 1129(b)(2)(A)(iii). In both cases, the "stalking-horse" bids that formed the starting point for the auction were well below both the total debt that the respective assets secured and even the apparent value of those assets.

Amalgamated filed objections to the bid procedures motions, asserting that because the debtors' plans sought to sell assets free and clear of liens while precluding credit-bidding, they contravened the express terms of the Bankruptcy Code and could not be confirmed. In response to the debtors' alternative approach, Amalgamated contended that the debtors had also failed to demonstrate sufficient cause to deny credit-bidding. The court agreed with Amalgamated that as a matter of law any sale free and clear of liens under a plan had to proceed under § 1129(ab)(2)(A)(ii). Thus, the debtors would have to prove that there was cause to deny the lenders the right to credit-bid. After a trial, the court also found that the debtors had failed to show any such cause.

The debtors' appeal of the bankruptcy court's orders[11] was fast tracked to the Seventh Circuit pursuant to 28 U.S.C. § 158(d), which authorizes a direct appeal under certain circumstances.[12] On June 29, 2011, the Seventh Circuit BAP unanimously affirmed the bankruptcy court's decision,[13] creating a split among the circuits because of the *Philadelphia Newspapers* decision by the Third Circuit.

Just over a week after the Seventh Circuit's decision, the lenders confirmed their own reorganization plan in the *River Road* cases, mooting any further appeal by those debtors. Notably, under the plan, the lenders deliberately left some value on the table for other creditors to which the lenders would otherwise have been entitled since there was no value in the debtors' assets over and above the amount of the lenders' secured claims. The *RadLAX* debtors petitioned the Supreme Court for a review by a *writ of certiorari*, which was granted on Dec. 12, 2011. Oral argument was held on April 23, 2012.

Parties' Arguments in the Supreme Court

The *RadLAX* debtors' fundamental argument in the Supreme Court was, as it had been, an appeal to the "plain language of the statute" rule of statutory interpretation. Relying primarily on the reasoning in *Philadelphia Newspapers*, the debtors contended that because § 1129(b)(2)(A) is phrased in the disjunctive "or," a plain reading of that section indicates that a plan can be confirmed as long as it meets the requirements of any one of the three subsections, regardless of whether the plan's structure more closely resembled another subsection.

Under the interpretation advocated by the debtors, a plan proponent has the flexibility to propose a plan that provides for a free-and-clear sale of assets without credit-bidding so long as the plan provides the "indubitable equivalent" of the secured claims. In other words, the debtors asserted that § 1129(b)(2)(A)(ii) does not exhaust the field when it comes to plan sales free and clear of liens. Instead, they argued that a plan sale free and clear can also proceed under § 1129(a)(iii), which includes no requirement that the secured creditor be allowed to credit-bid absent cause. The debtors contended that the proceeds of sale could provide the lenders with the indubitable equivalent of their claims, although they acknowledged that the lenders were at confirmation entitled to challenge whether the sale proceeds did so.

In this connection, the debtors expressed the view that the bankruptcy court could conclude from the marketing and

9 *In re Phila. Newspapers LLC*, 599 F.3d 298, 318 (3d Cir. 2010).

10 The Third Circuit found support for its ruling in a prior decision of the U.S. Court of Appeals for the Fifth Circuit. *Bank of N.Y. Trust Co. NA v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009).

11 The appeal was limited to the issue of whether the bankruptcy court erred in holding that the debtors must proceed under 11 U.S.C. § 1129(b)(2)(A)(ii) and provide their secured creditors with an opportunity to credit-bid where the debtors proposed, under a reorganization plan, to sell free and clear of liens the collateral securing such secured creditors' claims. The debtors did not appeal the court's determination that "cause" to deny the lenders the right to credit-bid pursuant to 11 U.S.C. § 363(k) did not exist.

12 28 U.S.C. § 158(d)(2)(A) provides in relevant part:

> The appropriate court of appeals shall have jurisdiction of appeals...if the bankruptcy court, the district court or the bankruptcy appellate panel involved, acting on its own motion or on the request of a party to the judgment, order or decree described in such first sentence, or all the appellants and appellees (if any) acting jointly, certify that—
>
> (i) the judgment, order or decree involves a question of law as to which there is no controlling decision of the court of appeals for the circuit or of the Supreme Court of the United States, or involves a matter of public importance;
>
> (ii) the judgment, order or decree involves a question of law requiring resolution of conflicting decisions; or
>
> (iii) an immediate appeal from the judgment, order or decree may materially advance the progress of the case or proceeding in which the appeal is taken.

13 *River Rd. Hotel Partners LLC v. Amalgamated Bank (In re River Rd. Hotel Partners LLC)*, 651 F.3d 642 (7th Cir. 2011).

auction *process* alone that the sale provided the indubitable equivalent, but also conceded that other evidence—such as appraisals—might be relevant. The debtors also added some secondary arguments of less note. One was essentially that if the Supreme Court affirmed the decision, debtors would never be able to confirm a plan and provide benefits to other creditors in cases in which the debtor is underwater.

Amalgamated's arguments appealed to both principles of statutory interpretation and policy considerations. In connection with statutory interpretation, **Deanne Maynard** first rejected the debtors' "disjunctive" argument by pointing out that there was no dispute that subsections (i), (ii) and (iii) were, indeed, in the disjunctive. However, the question was not simply whether they were in the disjunctive, but what the contents of the disjuncts were; in other words, the issue is, "or *what*." Does subsection (ii) exhaust the field when it comes to any kind of plan sale free and clear, or does subsection (iii) include other kinds of free-and-clear sales in which the secured creditor cannot credit-bid?

In connection with such statutory construction, Maynard pointed out that the basic rule is that the specific governs the more general. In this situation, it means that the provisions of subsection (ii), in which free-and-clear plan sales are *specifically* covered, are Congress's final words on such plans and sales. Whatever subsection (iii) and its indubitable-equivalence standard includes within its "or," it does not include free-and-clear plan sales.

Turning to policy considerations, Maynard argued that there are no good policy arguments that support the debtors' position. As long as a secured creditor's collateral is worth less than the amount of its claim, there is *no* value for *any other junior creditor*. Thus, confirming a plan that produces a cash sale price that is below the secured creditor's claim cannot benefit any other bankruptcy-recognized constituency junior to the secured creditor, although it might benefit the buyer (who, as in *RadLAX*, included opportunities for insiders) if the price is also less than the real value of the collateral. The latter might very well occur if the creditor lacks access to funds to cash-bid. In this connection, there is no rational purpose in requiring a secured creditor to put cash into an estate with one hand via a cash bid, only to take it all back with the other because the collateral is worth less than its claim.

On a larger scale, the debtor's position violates the traditional rule that a secured creditor is entitled to its money or its collateral, a rule that is embedded in various Bankruptcy Code provisions. For example, an undersecured creditor's right to make an election to be treated as fully secured under § 1111(b)(2) provides some protection for a creditor from being cashed out at too low a value. Normally, an undersecured creditor is entitled to a stream of payments having the present value of a secured claim measured by the value of the collateral underlying its claim; the undersecured portion of the claim is treated as an unsecured claim, which may be paid pennies on the dollar, or even nothing. Moreover, such a creditor risks being underpaid on his secured claim if the bankruptcy court undervalues his collateral. This is a serious risk; courts have repeatedly recognized that the valuation of collateral not already priced on a regular market (such as publicly traded stock) is a somewhat speculative exercise. But when a creditor makes the § 1111(b) election, although the stream of payments must still have only the present value of the collateral, it must total the gross amount of the creditor's claim (that is, both the secured portion and what would otherwise be the unsecured portion). Thus, while such a creditor still faces the risk of misvaluation of the collateral by a bankruptcy court in determining what the present value of the payment stream must be, Congress has given the secured creditor some back-end protection in the form of the objective number represented by the gross amount of its claim.

Section 363(k) provides the secured creditor with another form of protection against undervaluation of its collateral. That protection is granted because if the secured creditor is not satisfied that the amount offered by another buyer is acceptable (*e.g.*, close enough to the secured creditor's view of the collateral's real value), the secured creditor can try to force the bid up by credit-bidding up to the full amount of its claim, at which point any overbid would both pay that creditor in full *and* produce a surplus for other creditors.

Maynard urged that it does not make sense to suppose that Congress left an enormous hole in the protective scheme for secured creditors represented by §§ 363(k) and 1111(b) by allowing free-and-clear sale plans that prohibit credit-bidding. Nor is there any policy reason why Congress would permit treatment of secured creditor claims differently in free-and-clear plan sales from sales under § 363(b). Finally, of course, Maynard pointed out that Amalgamated's view preserves the secured creditor's traditional right to either be paid its claim or get its collateral that its customary right to credit-bid under state law allows.

Addressing the debtors' argument that Amalgamated's position means that it will be impossible to confirm plans in many cases, Maynard made several points. First, she noted that since there is no value for other creditors in an underwater estate except what the secured creditor may choose to make available to them (as the lenders did in their *River Road* plan), there can be no plan without the secured creditor's consent. Nothing in the Bankruptcy Code contemplates transferring a secured creditor's value to other interests over that creditor's objection, most especially not to a stranger to the bankruptcy process such as a buyer. Moreover, although a secured creditor is entitled to its money or its property, most secured creditors do not want the property. Hence, they are often willing to agree to a plan under which they get enough money on account of their collateral to warrant avoiding the hassle of foreclosing on, caring for, and marketing the property. In such circumstances, a *consensual* plan is often worked out under which some value that would not otherwise be available goes to other creditors with the secured creditor's blessing.

Final Word: Specific Governs the General

The Supreme Court affirmed the Seventh Circuit's decision in an opinion based on established principles of statutory interpretation. The Court found that no textual ambiguity existed in § 1129(b)(2)(A), and therefore, there was no need to consider pre-Code practices, the merits of credit-bidding or the objectives of the Bankruptcy Code.[14] As well, the unanimous opinion eschewed considerations of policy. The Court's opinion leaves little room for debate and contains no

14 *RadLAX*, 2012 U.S. LEXIS 3944, at *17.

stray comments or *dicta* upon which future parties and courts might seize to undermine the decision.

The opinion, authored by Justice Antonin Scalia, held that the debtors' reading of § 1129(b)(2)(A)—"under which clause (iii) permits precisely what clause (ii) proscribes—to be hyperliteral and contrary to common sense."[15] Relying on the "general/specific canon" of statutory construction, the Court noted that clause (ii) is a detailed provision that describes the requirements for selling collateral free of liens, while clause (iii) is a broadly worded provision that says nothing about such a sale. "The general/specific canon explains that the 'general language' or clause (iii), 'although broad enough to include it, will not be held to apply to a matter specifically dealt with' in clause (ii)."[16] More specifically,

> the structure of the statute...suggests that clause (i) is the rule for plans under which the creditor's lien remains on the property, (ii) is the rule for plans under which the property is sold free and clear of the creditor's lien, and (iii) is a residual provision covering dispositions under all other plans—for example, one under which the creditor receives the property itself, the "indubitable equivalent" of its secured claim. Thus, debtors may not sell their property free of liens under § 1129(b)(2)(A) without allowing lienholders to credit-bid, as required by clause (ii).[17]

In addition to addressing the textual arguments, the Court's questioning at oral argument also focused on policy and the practical implications of allowing free-and-clear sales without credit-bidding. The Court's underlying concerns were not absent from its opinion. In an apparent nod to the effects its decision might have on the federal government—"which is frequently a secured creditor in bankruptcy and...often lacks appropriations authority to throw good money after bad in a cash-only bankruptcy auction"[18]—the Court, in a footnote, gave heed not only to the fundamental protections that credit-bidding provides to secured creditors, but also to the logistical hurdles that the U.S., as a secured creditor, would have to face if the Court were to adopt the debtors' position.

Conclusion

Philadelphia Newspapers provided the template for a credit-bid override in the context of a free-and-clear plan sale. From the perspective of third parties, this template presented the potential for acquiring assets at attractive valuations where the secured creditor elects not to, or simply cannot, cash bid. From the secured creditor's perspective, the decision in *Philadelphia Newspapers* posed a very real threat to its bargained-for state law rights and long-held expectations concerning its ability to get its money or its collateral. In this regard, *RadLAX* is a critical victory for the secured lending community, effectively restoring their bedrock protections. But although *RadLAX* settles this issue decisively in favor of secured creditors, it does not necessarily spell the end for cases or other creditors in which a secured creditor's claim consumes an estate. For as noted above, although a secured creditor generally wants its money or its property, it is often willing to compromise its rights because it would rather have money than its collateral. Moreover, secured creditors can perhaps expect debtors to explore more vigorously whether there is "cause" under § 363(k) to deny a secured creditor the right to credit-bid. abi

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15 *Id.* at *3.
16 *Id.* at *13.
17 *Id.* at *14-15.
18 *Id.* at *9, n. 2.