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The Saga of a Secured Lender's Right to Credit Bid Continues

Seventh Circuit Rejects Third Circuit Approach and Upholds Secured Lender's Right to Credit Bid in Sale Pursuant to a Bankruptcy Plan

BY THE FINANCE AND RESTRUCTURING PRACTICE

A secured lender's well-worn tools to protect its security interest have included the right to credit bid when its collateral is being sold. Credit bidding refers to the ability of a secured lender to participate in a foreclosure or other form of sale of assets that are subject to its liens and, where the cash bids yield less value than the secured lender believes its collateral to be worth, to bid all or a portion of its debt in lieu of cash. Because any cash the secured lender pays would be round-tripped back to itself as proceeds of collateral, the lender need not actually put cash on the table; instead, it reduces the underlying debt by the amount of its credit bid to take title to the collateral.

The same process has been long recognized and accepted in bankruptcy cases as well, and many lenders assumed the right to credit bid was absolute.[1] That right, however, has come under attack in several high profile cases, notably in appeals arising in the chapter 11 cases (i) *In re Philadelphia Newspapers, LLC*,[2] in which the Third Circuit Court of Appeals ruled that a debtor may, pursuant to a bankruptcy plan, sell the secured creditor's collateral free and clear of liens, and need not provide the secured lender with a right to credit bid in the sale process, so long as the plan otherwise provides the secured lender with the "indubitable equivalent" of its secured claim, and (ii) *In re Pacific Lumber Co.*, in which the Fifth Circuit Court of Appeals authorized a debtor to sell the debtor's encumbered assets under a bankruptcy plan to a specified purchaser for an amount equal to a judicially-determined value of the assets but did not permit credit bidding. The Third Circuit Court of Appeals is a federal court with appellate jurisdiction over courts sitting in Delaware, New Jersey, and Pennsylvania and the Fifth Circuit Court of Appeals is a federal court with appellate jurisdiction over courts sitting in Texas, Louisiana, and Mississippi. The Seventh Circuit Court of Appeals, a federal court with appellate jurisdiction over courts sitting in Illinois, Indiana, and Wisconsin, has now weighed in on the same issue in an appeal arising in the chapter 11 case *In re River Road Hotel Partners, LLC*, but with the opposite result—the *River Road* court just ruled that a debtor cannot, under a bankruptcy plan, sell a secured lender's collateral free and clear of liens without providing the secured lender the right to credit bid in the sale process.

"Cram Down" Provisions of Bankruptcy Code Section 1129(b)

The decisions in *River Road Hotel Partners, LLC v. Amalgamated Bank (In re River Road Hotel Partners)*, Nos. 10-3597 & 10-3598 (7th Cir. June 28, 2011), *Citizens Bank of Penn. v. Phila. Newspapers, LLC (In re Philadelphia Newspapers)*, 599 F.3d 298 (3rd Cir. 2010), and *Bank of N.Y. Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009), each arise under the "cram down" provisions of Bankruptcy Code section 1129(b).[3] That section permits a debtor (or other plan proponent) to confirm a chapter 11 plan over the objection of a class of creditors (such as secured creditors), so long as the plan (i) does not discriminate unfairly among classes of claims or interests and (ii) is fair and equitable with respect to those classes of claims or interests that have not accepted the plan. Section 1129(b)(2)(A) states that a plan is "fair and equitable" with respect to a class of secured claims if the plan provides:

> (i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property.
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> (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
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> (iii) for the realization by the holders of the indubitable equivalent of such claims.[4]

Clause (ii) quoted above references section 363(k), which assures the right of a secured lender to credit bid where its collateral is being sold outside of a plan, as follows:

> At a sale under subsection (b) of this section [*i.e.*, a sale outside of the ordinary course of business] of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.[5]

In short, section 1129(b)(2)(A) permits a plan to be crammed down on a non-consenting class of secured creditors as long as one of three tests is met: (1) the secured creditors keep their liens and receive satisfactory deferred cash payments under clause (i); (2) assets are sold free and clear of liens where the secured creditors are permitted to credit bid under clause (ii); or (3) the secured creditors receive the "indubitable equivalent" of their claims under clause (iii). The Bankruptcy Code nowhere defines "indubitable equivalent," however, and examples in case law vary widely.

River Road Hotel Partners Decision

As set forth above, clause (ii) of section 1129(b)(2)(A) unequivocally permits the sale of collateral free and clear of liens, subject to the secured creditor's right to credit bid. The question addressed by the three-judge panel in *River Road Hotel Partners*, however, was whether clause (ii) provides the

exclusive "fair and equitable" means to sell collateral free and clear of liens, such that the right to credit bid must always be respected. The panel unanimously said "yes."

Before discussing the holding, some factual context is helpful. The *River Road* debtors had proposed two separate plans to sell substantially all of their assets free and clear of liens at a public auction. The debtors selected a stalking horse bidder, which proposed to buy the assets for approximately $89.5 million in value. The debtors sought bankruptcy court approval of bid procedures to solicit higher and better offers but specifically provided that offers had to be in cash (i.e., no credit bids were allowed). The secured creditors, whose collateral was being sold and who held secured claims of approximately $260 million, voted to reject the plans and objected to the bid procedures because they precluded the secured creditors from credit bidding. The bankruptcy court agreed with the secured creditors that (for the debtors to cram down the secured creditors) the debtors could only sell their assets free and clear of liens by proceeding under clause (ii) of section 1129(b)(2)(A), which expressly requires a sale to be subject to the credit bid provisions of section 363(k). The bankruptcy court therefore ruled that the debtors' plans could not be confirmed and subsequently entered orders denying entry of the debtors' request to establish bid procedures. The Seventh Circuit Court of Appeals entered certifications for direct appeal at the debtors' request.

The Seventh Circuit affirmed and held that the Bankruptcy Code requires all cramdown plans that contemplate selling encumbered assets free and clear of liens at an auction to permit secured creditors to credit bid. *Id.* at 24. On appeal, the debtors argued that the plain meaning of section 1129(b)(2)(A)(iii) permits confirmation of a plan proposing a sale of encumbered assets free and clear of liens without allowing the secured creditor to credit bid as required by section 1129(b)(2)(A)(ii). *Slip Op*. at 20. The Seventh Circuit rejected the debtors' suggested reading of the statute, citing two reasons. First, citing Judge Ambro's dissent in *Philadelphia Newspapers*, the Seventh Circuit found that section 1129(b)(2)(A)(iii) has more than one plausible interpretation when read in connection with clauses (i) and (ii). The court noted that the "indubitable equivalent" prong of clause (iii) could be read either: (1) generally to permit a plan where the secured creditor realizes upon its claims by *any means* that provide the creditor with the "indubitable equivalent" of that secured claim, including plans providing for the retention of liens and sale of assets; or (2) to be limited in scope to circumstances *other than* lien retention (under clause (i)) or asset sales free and clear of liens (under clause (ii)). *See id*. at 16. Second, noting that the prohibition of credit bidding increases the risk that a secured creditor may not receive the indubitable equivalent of its claims at a bankruptcy auction, the Seventh Circuit concluded that, read in isolation, the language of clause (iii) does not unambiguously provide that a plan proposing to sell a debtor's encumbered assets free and clear of a secured creditor's liens while precluding credit bidding qualifies as "fair and equitable". *See id*. at 17.

Finding an ambiguity between its interpretation and that suggested by the debtors, the panel then looked to principles of statutory construction, specifically to rules that (1) disfavor interpretations that result in provisions being superfluous, (2) specific clauses prevail over general clauses, and (3) encourage interpretations that produce effects that are "compatible with the rest of the law". *Id.* at 20-21. The Seventh Circuit charged that the debtors' interpretation of the application of section 1129(b)(2)(A)(iii) renders clause (ii) superfluous; that is, if clause (ii) requires a sale free and clear to permit credit bidding, and clause (iii) neither forbids nor requires credit bidding, then clause (ii) is entirely superfluous. *See id.* at 21-22. The same would be true of clause (i); that is, under the majority's analysis, clause (iii) could arguably be used to circumvent the strict requirements of clause (i) when a secured creditor is maintaining its liens. Moreover, the debtors' interpretation would likewise run afoul of the rule that specific clauses prevail over general clauses. *See id.* at 22, n.7.

Since clause (ii) specifically addresses sales free and clear of liens, the Court noted, then the general "catchall" language of clause (iii) cannot also be read to address sales free and clear of liens because it places the two clauses in conflict and would permit the general to subsume the specific. *Id*. Finally, the Seventh Circuit also noted that other provisions of the Bankruptcy Code reveal an interest in ensuring that secured creditors are appropriately protected, including the right to credit bid pursuant to section 363(k) and the anti-lien stripping provisions of section 1111(b). In its view, the right of a secured creditor to credit bid in a sale pursuant to a plan in a cramdown scenario is consistent with that intent. *See id.* at 23-24.

Observations

It is important to note that the repercussions of *River Road* may not be fully understood for some time because, procedurally, a number of avenues remain open to the parties to that appeal. The debtors may seek an *en banc* rehearing or, ultimately, Supreme Court review (because the Seventh Circuit's decision in *River Road* has created a split among the United States Courts of Appeals, such contradictory rulings could interest the Supreme Court). In addition, the secured creditors have proposed their own plan, which is scheduled for hearing on June 29, 2011, and consummation of that plan could moot an appeal of the Seventh Circuit decision.

On its merits, the *River Road* decision lends weight to Judge Ambro's dissent in *Philadelphia Newspapers*—that legislative intent was to require that all bankruptcy asset sales free and clear of liens under the cramdown provisions must be conducted pursuant to clause (ii) of section 1129(b)(2)(A), particularly when the dispute is viewed against the backdrop of settled business expectations as to what it means to hold a security interest.

It is currently the law of the Seventh Circuit that a secured creditor has the right to credit bid when a plan seeks to sell the secured creditor's collateral free and clear of its liens, while a secured creditor can be precluded from credit bidding in a cramdown scenario in the Third Circuit (and indeed in the Fifth Circuit). It remains to be seen how other circuits will react to attempts by debtors to sell secured creditors' collateral without honoring the right to credit bid. The heightened degree of uncertainty as to whether a secured creditor will be able to realize upon its collateral during a bankruptcy case may cause lenders in the future to adjust the terms of loans to compensate the lenders for that uncertainty, and perhaps lead to greater efforts to realize upon collateral outside of a chapter 11 case. In addition, until resolution of this issue by the Supreme Court, the circuit split may result in increased forum shopping by distressed companies who choose to file for chapter 11 protection in the Third Circuit (with appellate jurisdiction over courts sitting in Delaware, New Jersey, and Pennsylvania) or the Fifth Circuit (with appellate jurisdiction over courts sitting in Texas, Louisiana, and Mississippi) to attempt to deprive their secured creditors of the right to credit bid.

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[1] Section 363(k) of the title 11 of the United States Code provides that:

> [a]t a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

11 U.S.C. § 363(k).

[2] This law firm prepared a Client Alert addressing the Third Circuit Court of Appeal's decision in Philadelphia Newspapers in March 2010, a copy of which can viewed at http://www.paulhastings.com/assets/publications/1554.pdf.

[3] Unless otherwise indicated, all section references are to the United States Bankruptcy Code, 11 U.S.C. § 101, et seq.

[4] 11 U.S.C. § 1129(b)(2)(A)(i)-(iii).

[5] 11 U.S.C. § 363(k).