Quite to the Contrary … There is a Supreme Right to Credit Bid

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In the April 2010 *ABF Journal* article, "*In re Philadelphia Newspapers, LLC*: The Not-So-Secured Right to Credit Bid," Jeffrey Wurst discussed the Third Circuit's decision that in a sale of assets under a plan of reorganization, a secured lender did not have the *right* to credit bid. Since then, the Seventh Circuit allowed the secured creditor to credit bid. The resulting U.S. Supreme Court decision in *RadLAX* held that a sale of assets under a plan cannot prevent a secured creditor from credit bidding.

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A previously published an article in the April 2010 issue of the *ABF Journal* entitled *"In re Philadelphia Newspapers, LLC:* The Not-So-Secured Right to Credit Bid," which discussed the significance of the decision of the Third Circuit Court of Appeals' holding that in a sale of assets under 11 USC §1123 and §1129 (i.e., under a plan of reorganization), a secured lender did not have the *right* to credit bid. That article also discussed a prior decision from the Fifth Circuit (covering Texas, Louisiana and Mississippi), which, although it did not go as far as the Third Circuit (Pennsylvania, New Jersey and Delaware) in denying the right to credit bid, served as foundation for the Third Circuit's decision.

Since that article was published some two and a half years ago, the Seventh Circuit (Illinois, Wisconsin and Indiana) took a position contrary to those of the Third and Fifth Circuits, allowing the secured creditor to credit bid in a sale to be effected under a plan of reorganization. As a result of the split in the circuits, the U.S. Supreme Court (in a decision much less controversial than its decision in the Affordable Care Act case) granted *certiorari* in *RadLAX*[1] and agreed to consider the credit bid issue.

Notwithstanding decades of bankruptcy jurisprudence, the Third Circuit held that, due to the disjunctive "or" within §1129(b)(2)(A)(ii), a plan of reorganization need only abide by the provisions of one subsection, even if that means failing another.

In *Philadelphia Newspapers*,[2] the debtors owed approximately $300 million to a group of secured lenders that were significantly undersecured by virtue of the assets being valued at a substantially lower amount than the debt. The debtors proposed a plan of reorganization that prohibited credit bidding by the secured lenders, arguing that credit bidding was not necessary because the sale would be conducted pursuant to §1123 and §1129.

Most, if not all, readers of this article are familiar with the workings of asset sales under §363 of the Bankruptcy Code. Section 363(k) provides for credit bidding as follows:

> At a sale under … this section … [a] holder [of a secured claim] may offset such claim against the purchase price of such property.

Unlike §363(k), §1123 and §1129 do not *expressly* provide for credit bidding. Accordingly, the secured lenders in *Philadelphia Newspapers* objected, arguing that §1129(b)(2)(A)(ii) guaranteed their right to credit bid.

Section 1129(b)(2)(A)(ii) provides that a plan of reorganization is fair and equitable to a holder of a secured claim where the plan provided:

> for the sale, subject to 363(k) … of any property that is subject to [] liens, [to be sold] 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 the indubitable equivalent of such claims.

*providing for retaining of liens

**providing for the realization by the holder of the lien

However, notwithstanding decades of bankruptcy jurisprudence, the Third Circuit held that, due to the disjunctive "or" within §1129(b)(2)(A)(ii), a plan of reorganization need only abide by the provisions of one subsection, even if that means failing another. Thus, the Third Circuit held, a plan must only provide that the secured creditors fulfill *any* of the following requirements: (i) retain their liens and receive deferred cash payment of their secured claim; (ii) retain the right to credit bid at any sale of their collateral; or (iii) receive the "indubitable equivalent" of their claim. In *Philadelphia Newspapers*, the Third Circuit held that the debtors' plan followed subsection (iii), and thus it did not matter that the plan was antithetical to subsection (ii).

In a biting dissent, Third Circuit Judge Tom Ambro argued that the decision was contradictory to congressional intent. According to Judge Ambro, §1129(b)(2)(A) is ambiguous, and so must be examined in the context of the Bankruptcy Code as a whole. When taken that way, he opined, it is clear that sales of collateral free and clear of liens under a plan fall within the purview of subsection (ii), and only subsection (ii).

Subsequent to the *Philadelphia Newspapers* decision, the Seventh Circuit in *River Road* [3] agreed with Judge Ambro. RadLAX Gateway Hotel, LLC, and RadLAX Gateway Deck, LLC, the debtors in *River Road*, also proposed a plan wherein the secured lenders would not be able to credit bid at a subsequent sale of the collateral. The Seventh Circuit held that §1129(b)(2)(A)(iii) is ambiguous, in that it could be either a general catch-all provision or one with a more limited scope.

The Seventh Circuit noted that "[t]he *infinitely* more plausible interpretation" of §1129(b)(2)(A) is the latter, wherein "plans could only qualify as 'fair and equitable' under Subsection (iii) if they proposed disposing of assets in ways that are not described in Subsections (i) and (ii)."[4] The broad interpretation would lead to incongruous results, as §363(k) explicitly and unequivocally grants a secured lender the right to credit bid. "In essence, by granting secured creditors the right to credit bid, the [Bankruptcy] Code promises lenders that their liens will not be extinguished for less than face value without their consent."[5]

A few months later, the Supreme Court granted *certiorari* to the debtors in *River Road* in order to resolve the circuit split, reviewing the Seventh Circuit decision in a decision entitled *RadLAX Gateway Hotel, LLC v. Amalgamated Bank.* And on May 29, 2012, the Supreme Court in *RadLAX*[6] upheld the Seventh Circuit's decision, holding that a sale of assets under a plan cannot prevent a secured creditor from credit bidding. It was a short opinion for what the court deemed "an easy case."

Notably, the court did not even consider the history of bankruptcy law, or the practical effects that the Third Circuit's interpretation of §1129(b)(2)(A) might have, despite the fact that court's line of questioning at oral argument focused on real world applications. Instead, the court stated, "As for pre-Code practices, they can be relevant to the interpretation of an ambiguous text, but *we find no textual ambiguity here*. And the pros and cons of credit-bidding are for the consideration of Congress, not the courts."[7]

Writing for a unanimous court,[8] Justice Scalia predicated his opinion on the canon of statutory construction that general language used in a statute can never override a specific prohibition elsewhere in the statute. As such, a sale free and clear of liens under a plan must abide by subsection (ii). Despite the debtors' arguments otherwise, this does not mean that a free and clear sale must abide by both subsections (ii) and (iii); instead, subsection (iii) is truly a catch-all provision, but it is applicable only in situations where subsections (i) and (ii), the more specific provisions of §1129(b)(2)(A), are inapplicable.

Of note is footnote 2 to the opinion, wherein Justice Scalia notes that the U.S. government itself acts as a secured lender through various programs, and thus has a keen interest in the ability to credit bid. Whereas many private lenders might be able to bid additional cash at an auction, which would be subsequently recouped up to the value of their claims, the U.S. government is rarely in such a position to do so. Thus, a reversal of *River Road* would, in effect, allow sales over even the federal government's objections.

In that same footnote, the Supreme Court also reinforced a protection for secured creditors: the right to credit bid up to the face amount of their secured claim, not just the value of their collateral at the time of the sale. Such practice had been accepted throughout most bankruptcy and district courts, but there is only one circuit court to have spoken on this issue, agreeing with the majority of lower courts.[9] The Supreme Court has now left no doubt.

Quite simply, the Third Circuit's interpretation of §1129(b)(2)(A) was, as the Supreme Court termed, "hyperliteral and contrary to common sense." The Bankruptcy Code is rife with checks and balances in an attempt to protect both debtors and creditors without giving one side too much power. For example, under §1129, the debtor proposes the plan, which requires approval from the creditors. However, a creditor's rejection can be crammed down under certain situations. *Philadelphia Newspapers* greatly eroded the power of secured creditors in a Chapter 11 case. Thankfully, the Supreme Court has now reestablished some semblance of balance, even if its opinion was based solely on dry statutory interpretation and influenced by power of the federal government, not necessarily private secured lenders.

Even with this reaffirmed protection, secured lenders should still actively seek to protect their rights at all stages of a bankruptcy. For example, early in the bankruptcy, secured creditors should seek to obtain a determination of the full amount of their claim, perhaps in a cash collateral or debtor-in-possession financing order. If the secured lender believes a judicial valuation of its claim to be too low, it can always seek the safeguard of §1111(b), which allows secured creditors to elect to have the entirety of their debt treated as secured, even if the collateral itself has a lower value. Additionally, the right to credit bid is not entirely absolute. Under §363(k), a court can prevent a secured lender from being able to credit bid "for cause." This was not at issue in *RadLAX*, but may serve as the next chapter by those seeking to deprive secured lenders of their now *Supreme* right to credit bid. abfj

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ENDNOTES

1 *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 845 (2011).

2 *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010).

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

4 *Id.* at 653 (emphasis added).

5 *Id.* at 650.

6 *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, No. 11-166, 2012 WL 1912197, __ U.S. __ (May 29, 2012).

7 *Id.* at *6 (emphasis added).

8 Justice Kennedy took no part in the decision.

9 *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 460 (3d Cir. 2006).