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Legal Update
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Seventh Circuit Upholds Secured Lenders' Right to Credit Bid in Asset Sales Under a Chapter 11 Plan

The US Court of Appeals for the Seventh Circuit has weighed in on the question of whether a secured creditor's ability to credit bid—to offset the amount of the creditor's debt against the purchase price of sale assets rather than bid in cash—is a right guaranteed by statute even in "cramdown" plans of reorganization conducted under Chapter 11 of the Bankruptcy Code. On June 28, 2011, the court ruled in favor of secured creditors with its much anticipated decision in *In re River Road Hotel Partners, LLC (River Road)*.[1]

By allowing a secured creditor to bid up to the full amount of the creditor's debt for the collateral, even where the fair market value of the collateral is less than the amount of the debt, the secured creditor is protected against the undervaluation of its collateral in the bankruptcy sale process. While Section 363(k) of the Bankruptcy Code guarantees the right of a secured creditor to credit bid in sales under Section 363, absent certain extraordinary circumstances, two recent opinions from the Third and Fifth Circuits had created substantial doubt as to whether the secured creditor's right to credit bid was, in fact, absolute.

In those appeals, arising in the context of asset sales conducted in conjunction with Chapter 11 plans of reorganization, the Third Circuit (*In re Philadelphia Newspapers, LLC*)[2] and the Fifth Circuit (*In re Pacific Lumber Co.*)[3] each held that a debtor may sell a secured creditor's collateral free and clear of liens **without** the requirement to provide the secured lender with a right to credit bid in the sale process. However, rejecting the reasoning of the Third and Fifth Circuits, a panel of the Seventh Circuit in *River Road* affirmed the bankruptcy court's decision that a plan of reorganization providing for a sale of encumbered assets may not be confirmed over the objection of a debtor's secured creditors, unless secured creditors are afforded the right to credit bid at the auction of their collateral.

Background

The *River Road* case involves two sets of debtors: the River Road Debtors, which own and operate the InterContinental Chicago O'Hare Hotel, and the RadLAX Debtors, which own and operate the Radisson Hotel at Los Angeles International Airport (the River Road Debtors and the RadLAX Debtors, collectively, the "Debtors"). At the time of their respective bankruptcy filings in August of 2009, the River Road Debtors owed their secured lenders approximately $155.5 million and the RadLAX Debtors owed their secured lenders approximately $142 million.

Following the bankruptcy filings, the River Road Debtors and the RadLAX Debtors sought to market and sell their assets free and clear of their respective lenders' liens. The River Road Debtors selected a stalking horse bidder that proposed to buy their assets for approximately $42 million (i.e., $113.5 million less than the indebtedness owing to the River Road Lenders) and the RadLAX Debtors had selected a stalking horse

bidder whose proposed purchase price of $47.5 million was nearly $94.5 million less than the indebtedness owing to the RadLAX Lenders. On June 4, 2010, the Debtors sought bankruptcy court approval of bid procedures to solicit higher and better offers for these purchase prices, but that would specifically deny Debtors' lenders, which did not support the sales, the right to credit bid.

Legal Framework, Bankruptcy Court Decision

The decision in *River Road*, as well as those in *Philadelphia Newspapers* and *Pacific Lumber*, arose under the "cramdown" provisions of Section 1129(b) of the Bankruptcy Code. In order to be confirmed, a plan of reorganization that proposes to force a secured creditor to accept plan treatment that it has otherwise rejected must demonstrate, among other things, that it is "fair and equitable" to the objecting class of secured creditors. To determine whether a plan meets this standard, Section 1129(b)(2)(A) of the Bankruptcy Code sets forth three alternative standards by which a plan may be deemed "fair and equitable" with respect to a rejecting class of secured creditors:

> (i) The holders of secured claims retain the liens securing their claims whether or not the debtor retains the property (the "Collateral Redemption Prong");
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> (ii) If the secured collateral is sold to a buyer free and clear of the liens, the sale must be subject to Section 363(k) (requiring that the secured creditors be allowed to credit bid unless the court orders otherwise "for cause") (the "Sale Prong"); or
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> (iii) That the plan provides for the rejecting secured creditors to receive the "indubitable equivalent" of their secured claims (the "Indubitable Equivalent Prong").

While the Sale Prong carries an express presumption that the secured creditor's right to credit bid will be protected in the event its collateral is sold free and clear of its lien, the Indubitable Equivalent Prong lacks any such express protection. At issue in *River Road*, *Philadelphia Newspapers*, and *Pacific Lumber* was the discrete question of whether a sale under a plan of reorganization could be confirmed under the Indubitable Equivalent Prong without providing secured creditors the ability to credit bid.

In *River Road*, the lenders argued that the Debtors sought under a plan to sell their encumbered assets free and clear of the lenders' liens, in direct violation of the Sale Prong, which guaranteed the lenders' rights to credit bid.

Relying on the prior decisions of *Philadelphia Newspapers* and *Pacific Lumber*, the Debtors argued that even though the Lenders were precluded from credit bidding in the asset sales, the plans were nevertheless confirmable under the Indubitable Equivalent Prong. The bankruptcy court denied the bid procedures motions and, finding the dissent of Judge Thomas Ambro in *Philadelphia Newspapers* persuasive, held that the Debtors could not use the Indubitable Equivalent Prong to prevent the Lenders from credit bidding at the plan sales. After the bankruptcy court's decision, the Debtors appealed directly to the Seventh Circuit.

The Seventh Circuit's Opinion

Finding Judge Ambro's dissent "more compelling," the Seventh Circuit declined to follow *Philadelphia Newspapers* and affirmed the bankruptcy court's decision that a cramdown plan seeking to sell encumbered assets free and clear of liens must permit secured creditors to credit bid under the Sale Prong. The Seventh Circuit further held that the Indubitable Equivalent Prong could only be used to confirm plans that dispose of a debtor's assets in ways other than those contemplated in the Collateral Redemption or Sale Prongs, contrary to the *Philadelphia Newspapers* and *Pacific Lumber* courts.

The Seventh Circuit explained that allowing a debtor to dispose of encumbered assets in the ways described in the Collateral Redemption or Sale Prongs, despite failing to meet the requirements of those subsections, would render those prongs superfluous. Moreover, the court noted that it "cannot conceive of a reasons why Congress would state that a plan must meet certain requirements if it provides for the sale of assets in particular ways and then immediately abandon these requirements in a subsequent subsection" (essentially by allowing the Indubitable Equivalent Prong to create an exception to the Collateral Redemption or Sale Prongs). Rather, the court held that the "infinitely more plausible interpretation" of the requirements of Section 1129(b)(2)(A) would require that plans could only be confirmed under the Indubitable Equivalent Prong if they proposed disposing of assets in ways that were not described in the Collateral Redemption or Sale Prongs.

Alternatively, the Seventh Circuit determined that even reading the Indubitable Equivalent Prong in isolation, ambiguity still existed as to what constituted the "indubitable equivalent" of a secured creditor's claim. Specifically, the Seventh Circuit noted that "there are a number of factors that create a substantial risk that assets sold in bankruptcy auctions will be undervalued"[4] and because the lack of credit bidding in the proposed auctions would "deny secured lenders the ability to credit bid, they lack a crucial check against undervaluation." Thus, evaluating the Indubitable Equivalent Prong under a plain-meaning standard, the Seventh Circuit held that it could not be used to confirm a plan that proposed a "free and clear" asset sale without providing for credit bidding.

Finally, the court counseled that any interpretation of Section 1129(b)(2)(A) to allow for sales free and clear of liens without allowing secured creditors to credit bid would sharply conflict with the way that the interests of secured creditors were treated in other parts of the Code. In reviewing various sections of the Bankruptcy Code related to the sales of encumbered property free and clear of liens and protections afforded to secured creditors (including under Section 363(k) and 1111(b)), the Seventh Circuit stated that "the Code has an expressed interest in insuring that secured creditors are properly compensated" and, in contrast, "the Code does not appear to contain any provisions that recognize an auction sale where credit bidding is unavailable as a legitimate way to dispose of encumbered assets." As a result, the court concluded that "the Code requires that cramdown plans that contemplate selling encumbered assets free and clear of liens at an auction satisfy the requirements set forth in Subsection (ii) of the statute"—clearly mandating that at any such auction, secured lenders must be provided the opportunity to credit bid.

Observations

The *River Road* decision signals a significant victory for secured creditors, at least in the Seventh Circuit. However, the full weight of its impact may not fully be known for some time as other circuits may consider the issue. Moreover, as the decision has now created a split among the appellate circuits as to the interpretation of Section 1129(b)(2)(A)'s "fair and equitable" standards, such contradictory rulings may result in eventual Supreme Court review and determination of the issue. Thus, the Seventh Circuit's decision, while favorable to secured creditors, may not be the final word on the "absolute" right of secured lenders to credit bid in asset sales under plans of reorganization.

Endnotes

[1] *River Road Hotel Partners, LLC v. Amalgamated Bank (In re River Road Hotel Partners)*, Nos. 10-3597 & 10-3598, ___ F.3d ___, 2011 WL 2547615 (7th Cir. June 28, 2011). Although generally referred to as *In re River Road Partners, LLC*, the Appellate Court's decision actually addressed two related, jointly administered bankruptcy cases: *In re River Road Hotel Partners, LLC, et al.* (Case No. 10-3597) and *In*

re RADLAX Gateway Hotel, LLC (Case No. 10-3598), which had been consolidated for purposes of the appeal.

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

[3] *Bank of N.Y. Trust Co., N.A. v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*, 584 F3d 229 (5th Cir. 2009).

[4] Among other factors that contribute to the risk that an asset will be undervalued in bankruptcy asset sales, the Court noted: (a) the speed and timing of a bankruptcy auction; (b) the inability to provide adequate notice to interested parties; (c) the inherent risk of self-dealing on the part of existing management; (d) the liquidity constraints of the current credit markets; and (e) the fact that bidders, in expending their resources to put together a bid, will likely take such costs into account when the setting the value of their bids and increasing the chance that the asset's sale price does not reflect its actual value. *See River Road* at FN6.

For more information about the In re River Road Hotel Partners, LLC decision, or any other matter raised in this Legal Update, please contact either of the following lawyers.

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