# Seventh Circuit Rules That Secured Creditors Must Be Given the Right to Credit-Bid

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In a victory for secured creditors, the Seventh Circuit Court of Appeals recently held in *River Road Hotel Partners, LLC v. Amalgamated Bank (In re River Road Hotel Partners, LLC)*, 2011 WL 2547615 (7th Cir. June 28, 2011), that a dissenting class of secured lenders cannot be deprived of the right to credit-bid its claims under a chapter 11 plan that proposes an auction sale of the lenders' collateral free and clear of liens. The decision is a welcome development for secured creditors on the heels of contrary rulings handed down by the Third Circuit in *In re Philadelphia Newspapers*, 599 F.3d 298 (3d Cir. 2010), and the Fifth Circuit in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009). The resulting circuit split, however, may be a compelling invitation for review by the U.S. Supreme Court.

## The Bankruptcy Code's Cramdown Requirements

Section 1129(b) of the Bankruptcy Code sets forth the requirements that must be met before a bankruptcy court can confirm a chapter 11 plan over the objections of a dissenting class of creditors whose rights are impaired by the plan. Among these "cramdown" requirements is the dictate in section 1129(b)(1) that a plan "not discriminate unfairly" and that it be "fair and equitable" with respect to a dissenting class of creditors.

Section 1129(b)(2) addresses the "fair and equitable" requirement for different types of claims. Section 1129(b)(2)(A) provides three alternative ways to achieve confirmation over the objection of a dissenting class of secured claims: (i) the secured claimants' retention of their liens and

receipt of deferred cash payments equal to at least the value, as of the plan effective date, of their secured claims; (ii) the sale, "subject to section 363(k)," of the collateral free and clear of all liens, with attachment of the liens to the proceeds and treatment of the liens on proceeds under option (i) or (iii); or (iii) the realization by the secured creditors of the "indubitable equivalent" of their claims claim.

Section 363(k) of the Bankruptcy Code establishes the right of secured creditors to "credit-bid" by providing that when a debtor sells any property secured by a valid lien, unless the court orders otherwise "for cause," and if the holder of the secured claim purchases the property, "such holder may offset such claim against the purchase price of the property."

**The Dispute**

Courts disagree as to whether a secured creditor must be afforded the right to credit-bid its claims in a sale of its collateral pursuant to a chapter 11 plan in all circumstances. In particular, if a plan proposes to satisfy the "fair and equitable" requirement by providing the "indubitable equivalent" under section 1129(b)(2)(A)(iii)—which, unlike section 1129(b)(2)(A)(ii), is not expressly made "subject to section 363(k)"—some courts have held that the secured creditors in the affected dissenting class do not have the right to credit-bid in connection with the sale.

In *Philadelphia Newspapers*, for example, the Third Circuit sent shock waves through the commercial lending industry by ruling that a dissenting class of secured creditors can be stripped of the right to credit-bid their claims under a chapter 11 plan that proposes an auction sale of the creditors' collateral free and clear of liens. According to the court, the "indubitable equivalent" prong of the "fair and equitable" requirement set forth in section 1129(b)(2)(A) does not itself

require that a secured creditor be permitted to credit-bid its claim. Instead, the court held, the "indubitable equivalent" alternative requires a secured creditor to realize "the unquestionable value" of the creditor's secured interest in the collateral without the right to credit-bid.

Circuit judge Thomas L. Ambro wrote a vigorous 48-page dissent. Judge Ambro opined that section 1129(b)(2)(A) can reasonably be read as outlining the different requirements to satisfy the "fair and equitable" test, but that only one of the three requirements is applicable to any given class of secured creditors under a plan. The applicable requirement is determined by the treatment of the class of secured creditors. In addition, Judge Ambro would have applied the context of section 1111(b) and the legislative history of the provisions to conclude that "the Code requires cramdown plan sales free of liens to fall under the specific requirements of § 1129(b)(2)(A)(ii) and not to the general requirement of subsection (iii)."

*Philadelphia Newspapers* came closely on the heels of the ruling in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009), in which the Fifth Circuit similarly considered whether section 1129(b)(2)(A)(ii) is the only avenue to confirmation of a plan under which the collateral securing the claims of a dissenting secured class is to be sold. That court of appeals ruled that section 1129(b)(2)(A)(ii) does not always provide the exclusive means by which to confirm a plan where the sale of a secured party's collateral is contemplated. Rather, the Fifth Circuit held that, where sale proceeds provide a secured creditor with the indubitable equivalent of its collateral, confirmation of a plan is possible under section 1129(b)(2)(A)(iii). In addition, consistent with its conclusion that the sale transaction in the chapter 11 plan accomplished that result, the court

rejected an argument by noteholders that confirmation was improper because they had not been afforded the opportunity to credit-bid their claims for the assets.

Much is at stake for secured creditors in connection with this issue. Credit bidding and the option to elect fully secured status under section 1111(b) of the Bankruptcy Code are important rights designed to guard against judicial undervaluation of a secured creditor's collateral, particularly in circumstances where market conditions are not favorable to the realization of what the creditor views as a fair price for the property.

### ***River Road***

River Road Hotel Partners, LLC, and its affiliates (the "debtors") built and operated the InterContinental Chicago O'Hare Hotel from 2007 to 2009 with construction financing totaling more than $155 million. The debtors filed for chapter 11 relief in Illinois in August 2009. The debtors proposed joint chapter 11 plans contemplating the sale of substantially all of their assets pursuant to an auction process. They concurrently filed a motion for court approval of bidding procedures.

The lenders objected to the bidding-procedures motion and the plans, arguing that the plans were unconfirmable and that the procedures should not be approved because they violated the requirement of section 1129(b)(2)(A)(ii) that secured creditors be given the right to credit-bid if assets are to be sold free and clear of liens pursuant to a plan. The debtors countered that the proposed plans provided the lenders with the "indubitable equivalent" of their claims under section 1129(b)(2)(A)(iii), which does not require that the lenders be permitted to credit-bid their claims in connection with an auction sale of their collateral.

The bankruptcy court declined to approve the debtors' proposed bidding procedures because they denied secured creditors the right to credit-bid and, therefore, the debtors' proposed chapter 11 plans could never be confirmed. The debtors appealed and requested that the appeals be certified directly to the Seventh Circuit, which request was granted by the bankruptcy court.

## The Seventh Circuit's Ruling

A three-judge panel of the Seventh Circuit affirmed the ruling below. The court began by analyzing whether the language of section 1129(b)(2)(A) has a "plain and unambiguous meaning."

According to the Seventh Circuit, the language of section 1129(b)(2)(A) is ambiguous for two reasons: (1) there is nothing in the provision indicating whether subsection (iii) should have global applicability or be limited to those situations that are not covered by subsections (i) and (ii); and (2) the term "indubitable equivalent" is itself ambiguous and is particularly problematic with respect to undersecured claims.

The Seventh Circuit rejected the Third Circuit's reasoning in *Philadelphia Newspapers* that the use of the disjunctive "or" after section 1129(b)(2)(A)(ii) is a clear indication that subsection (iii) was meant to have global applicability. According to the court, Judge Ambro's dissent in *Philadelphia Newspapers* is more compelling on this point. The Seventh Circuit also rejected the debtors' argument that the proposed auction would determine the current market value of the assets to be sold and would thus deliver to the lenders the "indubitable equivalent" of their

secured claims. Instead, the Seventh Circuit noted, "[T]here are a number of factors that create a substantial risk that assets sold in bankruptcy auctions will be undervalued," including:

(1) The speed and timing of bankruptcy sales;

(2) Lack of sufficient notice and an abbreviated marketing process;

(3) The inherent risk of self-dealing;

(4) Credit markets in a state of limited liquidity; and

(5) The costs of submitting a bid in a court-supervised bankruptcy auction process.

The Seventh Circuit reasoned that the right of secured creditors to credit-bid is "a crucial check against undervaluation." Because "[n]othing in the text of Section 1129(b)(2)(A) indicates that plans that *might* provide secured creditors with the indubitable equivalent of their claims" can be confirmed, the court of appeals ruled that the debtors could not rely on section 1129(b)(2)(A)(iii) to auction off their assets without allowing the lenders to exercise their right to credit-bid.

Having concluded that the meaning of section 1129(b)(2)(A) is ambiguous, the Seventh Circuit proceeded to use "well established principles of statutory interpretation" to determine that the most plausible reading of the statute requires secured creditors to be given the right to credit-bid whenever assets are to be sold free and clear of liens pursuant to a chapter 11 plan.

First, the Seventh Circuit noted that statutes are to be interpreted so that "every part of the statute is meaningful" and no provisions are "superfluous." The court found that the debtors' proposed interpretation of section 1129(b)(2)(A) "violates a cardinal rule of statutory construction" because it would "render the other subsections of the statute superfluous." According to the

Seventh Circuit, it could not "conceive of a reason 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 [those] requirements." Therefore, the court concluded that requiring secured creditors to be allowed to credit-bid anytime assets are to be sold free and clear of liens is the "infinitely more plausible interpretation of Section 1129(b)(2)(A)."

Second, the Seventh Circuit explained that denying secured creditors the right to credit-bid by relying on section 1129(b)(2)(A)(iii) "sharply conflicts with the way that [secured creditors] are treated in other parts of the [Bankruptcy] Code." Specifically, the Seventh Circuit noted that section 363(k) and section 1129(b)(2)(A)(ii) expressly provide secured creditors with the right to credit-bid, and section 1111(b) of the Bankruptcy Code provides a means for secured creditors to protect their interests when a debtor seeks to keep possession of assets. Moreover, the court emphasized, there do not appear to be provisions in the Bankruptcy Code "that recognize an auction sale where credit-bidding is unavailable."

Because in its view eliminating a secured creditor's right to credit-bid would (1) "nullify" section 1129(b)(2)(A)(ii) of the Bankruptcy Code and (2) "ignore the protections for secured creditors" in other provisions of the Bankruptcy Code, the Seventh Circuit concluded that any chapter 11 plan that contemplates selling collateral free and clear of liens must allow secured creditors to credit-bid at the sale of their collateral.

## Outlook

Round 3 in the circuits goes to secured creditors, but the bout is far from over. On August 5, 2011, the debtors filed a petition for writ of certiorari, asking the U.S. Supreme Court to review

the Seventh Circuit's decision in *River Road* and resolve the split among the circuit courts of appeal on this issue. In early September, a group of seven law-school professors and the Loan Syndications and Trading Association separately filed briefs supporting the debtors' certiorari petition.