JONES DAY

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CREDIT BIDDING AND THE SUPREME COURT: WHAT HAPPENS NEXT?

On December 12, 2011, the Supreme Court granted a petition for certiorari in a case raising the question of whether a debtor's chapter 11 plan is confirmable when it proposes an auction sale of a secured creditor's assets free and clear of liens without permitting that creditor to "credit bid" its claims but instead provides the creditor with the "indubitable equivalent" of its secured claim. *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, No. 11-166 (cert. granted Dec. 12, 2011). In that case, the Seventh Circuit held that an objecting secured creditor class in a "cramdown" cannot be deprived of its right to credit bid its claims.

Credit bidding is widely used in bankruptcy cases because it allows the secured creditor to use the amount of its secured debt as all or part of its bid to acquire the asset. Section 363(k) of the Bankruptcy Code sets forth a creditor's right to credit bid. It authorizes a creditor to bid its secured debt claim to purchase the assets subject to the creditor's lien, unless the court orders otherwise "for cause." 11 U.S.C § 363(k). If the holder of the claim purchases the property, the "holder may offset such claim against the purchase price of [the] property." *Id.*

The credit bid process benefits secured creditors in at least two ways. First, it can increase the price of the assets that other prospective buyers must pay (which, presumably, makes it more likely the secured creditor will be made whole). Second, it can also enable the secured creditor to reacquire its assets without paying for the property twice—once when it extended the credit and a second time when it reacquires the asset. It also can benefit the debtor in that it provides an instant market for its assets with a known quantifiable value associated with the asset and thereby can enhance both the efficient administration of the estate and the return to all creditors. Moreover, credit bidding can provide a market test for the assets subject to the sale. This advances traditional bankruptcy objectives such as maximizing the value of estate assets and grounding asset sales in present-value, market-based metrics.

The Supreme Court's decision, which is expected toward the end of the Court's Term in June 2012, may well resolve a split among the Third, Fifth, and Seventh Circuits. This decision likely will have significant implications for secured creditors in the context of chapter 11 cases where they wish to use their security interest to credit bid in an attempt to increase the price of or to reacquire their collateral.

Section 1129(b) of the Bankruptcy Code contains the applicable standards that must be met before the bankruptcy court can confirm a chapter 11 plan over objections to the plan by a class of creditors whose rights will be impaired by the proposed plan. These "cramdown" requirements for secured creditors are found in section 1129(b)(2)(A), which provides:

> With respect to a class of secured claims, the plan provides—
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> (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**
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> (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 such holders of the indubitable equivalent of such claims.

11 U.S.C. §1129(b)(2)(A) (emphasis added).

Several circuits have recently parted ways in their interpretation of this section and created a circuit split requiring Supreme Court resolution of the issue.

In *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010), and *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009), the Third Circuit and Fifth Circuit, respectively, held that when a debtor proposes to sell an asset in which a creditor has a security interest as part of a chapter 11 plan, the secured creditor is not entitled to bid the value of its secured claim as long as it receives the "indubitable equivalent" of its secured claim as a result of the sale. *Philadelphia Newspapers*, 599 F.3d at 310-18; *Pacific Lumber*, 584 F.3d at 244-47. These courts read the "or" between subparagraphs (ii) and (iii) of section 1129(b)(2)(A) as isolating each subparagraph. Further, they determined that as long as the proposed plan contemplating a sale of assets subject to a security interest satisfied either subparagraph (ii) or (iii) in Section 1129(b)(2)(A), the plan was confirmable. At the time these opinions were issued, they conflicted with widely held and applied views that if a debtor proposed to *sell* assets subject to a security interest pursuant to a plan, the debtor was required to comply with subparagraph (ii), and the secured creditors were permitted to credit bid as part of the sale process.

In 2011, the Seventh Circuit—in contrast to the Third and Fifth Circuit holdings discussed above—held that when a debtor proposes to *sell* assets subject to a security interest pursuant to a chapter 11 plan, the debtor must comply with subparagraph (i) or (ii) of section 1129(b)(2)(A). *River Road Hotel Partners, LLC, et al. v. Amalgamated Bank*, 651 F.3d 642, 646-53 (7th Cir. 2011). Specifically, the debtor must either: (i) sell the encumbered asset with the secured creditors retaining their liens; *or* (ii) sell the encumbered asset free and clear of liens, with the liens attaching to the sale proceeds, and permit the secured creditor to credit bid as part of the sale. *River Road*, 651 F.3d at 652.

The Seventh Circuit held that a plan may be confirmed under subparagraph (iii) *only* if the proposed disposition of the assets subject to a security interest is undertaken in a manner other than what is outlined in subparagraphs (i) and (ii). Thus, subparagraph (iii) does not satisfy the requirement for a sale of encumbered assets pursuant to a plan. *Id.* If a debtor proposes to sell an encumbered asset, it must do so under either subparagraph (i) and provide for the lien to remain intact, or subparagraph (ii) and permit credit bidding. According to the Seventh Circuit, subparagraph (iii) cannot be relied upon as an alternative mechanism for a sale where credit bidding is prohibited or the liens do not remain on the collateral. *Id.*

The court noted that, if subsection (iii) permitted a debtor to sell assets free and clear without credit bidding, then subsection (ii) would have no purpose. *Id.* In reaching this conclusion, the Seventh Circuit relied heavily upon the dissenting opinion in *Philadelphia Newspapers*, which set forth many of these same arguments. *See Philadelphia Newspapers*, 599 F.3d at 319-38. The Seventh Circuit also relied upon legislative history indicating that Congress intended to ensure secured creditors proper compensation for their collateral. Finally, the Seventh Circuit noted that the Bankruptcy Code does not authorize generally an auction sale of encumbered assets where credit bidding is unavailable. *River Road*, 651 F.3d at 652, note 8.

Pending the outcome of the Supreme Court's decision in *RadLAX*, debtors and other interested parties continue to propose chapter 11 plans that contemplate sales of encumbered assets while permitting secured creditors to credit bid as part of the sale process, *e.g., In re International Media Group, Inc., et al.*, Case No. 12-10140 (MFW) (Bankr. D. Del. 2012) (sale of assets where stalking horse bid is a $45 million credit bid). Hopefully, the Supreme Court's decision will provide some clarity with regard to a secured creditor's right to credit bid its claim upon the sale of its collateral under a chapter 11 plan.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Kevyn D. Orr
Washington
+1.202.879.5560
korr@jonesday.com

Beth Heifetz
Washington
+1.202.879.3878
bheifetz@jonesday.com

Dan T. Moss
Washington
+1.202.879.3794
dtmoss@jonesday.com