Insolvency and Restructuring Update

Seventh Circuit Delivers a Major Win for Secured Creditors; Holds that Secured Creditors Cannot be Denied Right to Credit Bid in a Sale Under a Plan

On June 28, 2011, in a much anticipated decision, a panel of the United States Court of Appeals for the Seventh Circuit, in *In re River Road Hotel Partners, LLC*,[1] affirmed a decision of the Bankruptcy Court for the Northern District of Illinois, Eastern Division, holding 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, where the secured creditors were denied the right to credit bid at the auction of their collateral. The Seventh Circuit's decision represents a significant victory for secured lenders.

The Seventh Circuit's opinion stands in direct contrast to two fairly recent opinions of the Third and Fifth Circuits, both of which held that sales of collateral pursuant to plans of reorganization do not need to provide secured creditors the right to credit bid if the secured creditors are provided the "indubitable equivalent" of their secured claims. In *In re Pacific Lumber Co.*,[2] the Fifth Circuit confirmed a plan of reorganization that denied a group of secured noteholders their asserted right to credit bid at a private judicial sale of certain timberland that was subject to the secured creditors' liens. Consistent with the Fifth Circuit's reasoning in *Pacific Lumber*, in *In re Philadelphia Newspapers, LLC*,[3] a split panel of the Third Circuit approved the debtors' bid procedures that did not permit secured creditors to credit bid at an auction of substantially all of the company's assets conducted pursuant to the debtors' plan of reorganization. Circuit Judge Thomas L. Ambro (a noted former bankruptcy practitioner) issued a lengthy dissenting opinion in that case, which was heavily cited with approval in *River Road*, rejecting the majority's conclusions that the plain meaning of the Bankruptcy Code required the result reached, and concluding that the Bankruptcy Code mandates that secured creditors have the right to credit bid in chapter 11 plan sales. In *River Road*, Judge Ambro's reasoning carried the day.

Background

Credit bidding allows a secured creditor to bid up to the full amount owed to it in certain sales of property of a debtor's estate that is subject to the secured creditor's lien. The purpose of credit bidding is to permit the secured creditor to obtain possession of its collateral rather than receive the proceeds of a sale at a price that it views as inadequate. Sales of property of the estate outside of the ordinary course of the debtor's business may be conducted pursuant to section 363(b) of the Bankruptcy Code or pursuant to a plan or reorganization. Section 363(k) of the Bankruptcy Code expressly authorizes credit bidding in sales conducted pursuant to section 363(b). Courts are now split as to whether similar rights exist when a secured creditor's collateral is sold pursuant to a plan.[4]

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[1] *In re River Road Hotel Partners, LLC*, Case No. 10-3597 (7th Cir. June 28, 2011).

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

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

[4] While in some cases a secured creditor could bid cash with the understanding that the cash would be round-tripped and distributed back to the secured creditor as a distribution under the plan (thus having a similar economic effect to credit bidding), this is often not practicable in the case of syndicated loan facilities with numerous lenders.

To be confirmed, a plan of reorganization that has not been accepted by a class of claimants entitled to vote on such plan must demonstrate, among other things, that the plan is "fair and equitable" with respect to such dissenting class. Section 1129(b)(2)(A) of the Bankruptcy Code sets forth three alternative methods by which a plan may be deemed "fair and equitable" with respect to a class of secured claims that rejects the plan. Under subsection (i) (the most commonly used subsection), the holders of secured claims retain the liens securing their allowed claims and receive deferred payments having a present value equal to the value of their collateral; under (ii), the collateral is sold free and clear of the liens, with the liens attaching to the proceeds of such sale, *so long as the secured creditor is permitted to credit bid*; and under (iii), the plan provides for the secured creditors to receive the "indubitable equivalent" of their secured claims (an undefined term that generally means substituted value such that the secured creditor receives the benefit of its bargain).[5]

At issue in *River Road*, *Philadelphia Newspapers*, and *Pacific Lumber* was the question of whether subsection (ii)'s requirement that secured creditors have the right to credit bid in a chapter 11 plan sale can be circumvented by seeking confirmation of the plan under subsection (iii) without providing secured creditors the right to credit bid.

In re River Road Hotel Partners, LLC

In *In re River Road Hotel Partners, LLC*, the Debtors sought to sell substantially all of their assets pursuant to plans of reorganization. The assets at issue include the InterContinental Chicago O'Hare Hotel and affiliated event space (owned by the "River Road" debtors) and the Radison Hotel at Los Angeles International Airport (owned by the "RadLAX" debtors). The proposed procedures for conducting the asset sales under the plans denied the Debtors' secured lenders the right to credit bid.

Amalgamated Bank ("Amalgamated"), as agent for the secured lenders (including both the "River Road Lenders" and "RadLAX Lenders"), objected to the Debtors' proposed bid procedures on the grounds that they denied the secured lenders their rights to credit bid. The Debtors' argued that despite denying the secured lenders the opportunity to credit bid for their collateral, the Debtors' plans were nonetheless confirmable because they satisfied subsection (iii) of section 1129(b)(2)(A), providing the secured lenders with the "indubitable equivalent" of their secured claims.

The Bankruptcy Court disagreed with the Debtors, ruling that the Debtors' plans could not be confirmed under section 1129(b)(2)(A)(iii), and entering orders denying the Debtors' bid procedures motions. The Debtors' appeals of the Bankruptcy Court's rulings were certified directly to the Seventh Circuit.

The Court of Appeals' Opinion

The Court of Appeals for the Seventh Circuit affirmed the Bankruptcy Court's determination that the Debtors' plans could not be confirmed over the objections of secured creditors because the plans did not satisfy the "fair and equitable" standard – holding 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 [s]ubsection (ii) of [section 1129(b)(2)(A)]."[6]

The Court of Appeals rejected the Debtors' argument that the plain language of section 1129(b)(2)(A) (written in the disjunctive) permits a court to approve such a cramdown plan pursuant to subsection (iii)'s

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[5] 11 U.S.C. § 1129(b)(2)(A).

[6] *In re River Road Hotel Partners, LLC*, Case No. 10-3597 at 24 (7th Cir. June 28, 2011). At the beginning of its opinion, the Court of Appeals also found that despite arguments to the contrary the appeal was not moot and that even if found technically "moot," the action fit within certain exceptions to mootness "for cases that, due to timing issues, would otherwise evade review." *Id.* at 7-8.

requirement of providing the "indubitable equivalent." Instead, finding that section 1129(b)(2)(A) does not have only one plain meaning, the Court of Appeals applied principles of statutory construction to ultimately determine that the better interpretation of section 1129(b)(2)(A) would *not* permit confirmation of the Debtors' plans under subsection (iii), explaining that allowing a plan to dispose of encumbered assets in the ways described in subsections (i) or (ii), despite failing to meet the requirements of such subsections, would render such subsections superfluous. The Court of Appeals reasoned that the "infinitely more plausible interpretation of [s]ection 1129(b)(2)(A) would read each subsection as stating the requirements for a particular type of sale," interpreting each subparagraph as "conclusively governing" each category of proceeding it addresses.[7] "Under such a reading, plans could only qualify as 'fair and equitable' under [s]ubsection (iii) if they proposed disposing of assets in ways that are not described in [s]ubsections (i) and (ii)."[8]

Additionally, the Court of Appeals rejected the Debtors' argument that section 1129(b)(2)(A) "unambiguously indicates that a plan that provides a secured creditor with the proceeds from the sale of an asset at an auction that does not permit credit bidding satisfies the indubitable equivalence requirement."[9] The Court of Appeals instead found that auctions that denied secured creditors the right to credit bid lacked "a crucial check against undervaluation," which could lead to an increased risk that the winning bids would fail to provide the secured lenders with the current market value of their collateral.[10] On this issue of what satisfies the "indubitable equivalent" standard, *River Road* departs from the cases of *Philadelphia Newspapers*, where the Third Circuit did not address the question of whether the proposed treatment of the secured lenders would in fact satisfy the standard for indubitable equivalence, and *Pacific Lumber*, which involved a private sale and an extensive evidentiary hearing concerning the valuation of the collateral to be sold. Rather, in *River Road* the Debtors (unsuccessfully) argued that so long as the secured lenders received the proceeds of the highest available cash sale, that consideration would constitute the indubitable equivalent of their secured claims. Unlike the other two cases, the Court of Appeals in *River Road* used this argument to highlight just how "superfluous" subsection (ii) would be if the Debtors' argument were accepted and also to make a statement about the inherent rights and remedies of a secured creditor that must be considered for the indubitable equivalence test to be satisfied.

Finally, the Court of Appeals reasoned that in light of the fact that various provisions of the Bankruptcy Code reveal that "the Code has an expressed interest in insuring that secured creditors are properly compensated," but the Bankruptcy Code does not contain any provisions recognizing auctions of encumbered assets where secured creditors are denied the right to credit bid, section 1129(b)(2)(A) should be read to offer the standard protections to creditors found elsewhere in the Bankruptcy Code.[11]

Implications of the Decision

The Court of Appeals' holding is a significant shift in the tide of decisions on this issue, which had previously exhibited a consistent trend in the direction of narrowing the secured creditor's right to credit bid in the cramdown context. This decision should give debtors and other parties outside the Third and

[7] *Id.* at 23.

[8] *Id.*

[9] *Id.* at 15.

[10] *Id.* at 20 (emphasizing that "[n]othing in the text of [s]ection 1129(b)(2)(A) indicates that plans that *might* provide secured lenders with the indubitable equivalent of their claims can be confirmed under [s]ubsection (iii)).

[11] *Id.* at 23-24 (citing *Philadelphia Newspapers*, 599 F.3d at 331 (Ambro, J., dissenting)).

Fifth Circuits pause when seeking to craft bid procedures that would preclude credit bidding.[12] Additionally, the circuit split resulting from the Court of Appeals' decision may increase the likelihood of the issue of 1129(b)(2)(A)'s interpretation ultimately being heard by the U.S. Supreme Court.

It bears noting that, even where a secured creditor is precluded from credit bidding for its collateral, it will still retain the right to object to confirmation of the plan by arguing that the plan fails to provide the creditor with the "indubitable equivalent" of its secured claim. Moreover, while under the *Philadelphia Newspapers* and *Pacific Lumber* decisions, debtors seeking to thwart secured lenders from obtaining possession of their collateral had an incentive to attempt to effectuate asset sales through the longer and more expensive plan of reorganization route rather than pursuant to section 363(b) of the Bankruptcy Code, this new split of authority makes the strategic advantage of a sale under a plan far less certain.

- See a copy of the opinion.

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[12] The Court of Appeals recognized the "inherent risk of self-dealing on the part of existing management" in being incentivized "to favor 'white knight' bidders favorably disposed to preserving the existing business over others who might enter higher bids." *Id.* at 19 n.6.

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