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Seventh Circuit Affirms Bankruptcy Court Ruling That Sale of Assets Through Plan May Not Use "Indubitable Equivalent" Standard to Prevent Secured Creditors from Credit Bidding

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A recent Seventh Circuit opinion establishes a circuit split over the issue of whether debtors may prohibit credit bidding in connection with asset sales that are conducted through Chapter 11 plans. The authors analyze the decision and the circuit court split.

The Seventh Circuit recently issued an opinion[1] in the bankruptcy case of *River Road Hotel Partners, LLC* disagreeing with the Third Circuit's holding in *In re Philadelphia Newspapers, LLC*[2] regarding a free-and-clear sale of assets under a Chapter 11 plan that denied a secured creditor the right to credit bid. The Third Circuit had held that a sale of assets under a Chapter 11 plan could be confirmed under the "indubitable equivalent" test in clause (iii) of Section 1129(b)(2)(A) of the Bankruptcy Code without providing the right to credit bid preserved

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in clause (ii) of that same section. In *River Road*, the Seventh Circuit disagreed, finding that a sale free and clear of liens through a Chapter 11 plan must satisfy subsection (ii) and include the right to credit bid.

In particular, the Seventh Circuit noted that the ability to credit bid is "a crucial check against undervaluation," without which a sale of assets through a Chapter 11 plan "*might* [or might not] provide secured lenders with the indubitable equivalent of their claims."[3]

The Seventh Circuit further disagreed with the Third Circuit's interpretation of clause (iii) of Section 1129(b)(2)(A) of the Bankruptcy Code because it renders clauses (i) and (ii) superfluous and such interpretation "sharply conflicts" with the Bankruptcy Code's treatment of secured creditors in other sections of the Bankruptcy Code.[4]

BACKGROUND AND BANKRUPTCY COURT DECISION IN *RIVER ROAD*

The *River Road* decision involved two separate jointly administered Chapter 11 cases. In each of the cases, lenders were owed over $120 million for hotel construction loans. The debtors filed separate Chapter 11 plans to sell substantially all of their assets at auctions free and clear of liens and distribute the net sale proceeds to their creditors. They also filed bidding procedures providing that the lenders would not be allowed to credit bid at the auctions. The debtors argued that, while this procedure would not satisfy the confirmation requirements of Bankruptcy Code Section 1129(b)(2)(A)(ii), which would require secured lenders to be permitted to credit bid, their plans would still be confirmable under Section 1129(b)(2)(A)(iii) because it would provide the lenders with the "indubitable equivalent" of their claims.[5] The lenders' agent objected to the bidding procedures, and the bankruptcy court ruled in its favor, holding without substantive discussion that, while the debtors' attempt to circumvent credit bidding followed the majority decision in *Philadelphia Newspapers*, the court found the dissent from that case "more persuasive."[6] The case was then certified for direct appeal to the Seventh Circuit.

PHILADELPHIA NEWSPAPERS

In *Philadelphia Newspapers*, the debtors filed a Chapter 11 plan providing that substantially all of the debtors' assets would be sold at a public auction, and the assets would transfer free of liens. In an effort to ensure that the assets would be sold to the stalking horse, a buyer the debtors strongly preferred over the other likely bidders, the bidding procedures for the auction provided that "no holder of a lien on any asset of the Debtors [would be] permitted to credit bid pursuant to section 363(k) of the Bankruptcy Code" because the sale was "being conducted under section 1123(a) and (b) of the Bankruptcy Code, and not section 363 of the Bankruptcy Code."[7]

On appeal, the Third Circuit held, in a 2-1 decision, that the sale through a plan without allowing credit bidding was permissible. The court held that the disjunctive "or" in Section 1129(b)(2)(A) of the Bankruptcy Code meant that a debtor had the option of satisfying any of the three clauses (i) through (iii) and could choose to proceed under (iii) even if the sale of assets through a Chapter 11 plan fell under the description in (ii). The court further held that "indubitable equivalent" itself did not require that the lenders be allowed to credit bid, since "courts have concluded in a variety of circumstances that a debtor…provided the 'indubitable equivalent' of a secured lender's claim."[8] Finally, the court held that its reading of Section 1129(b)(2)(A) was not inconsistent with congressional intent because credit bidding and other protections provided to secured creditors under the Bankruptcy Code are not absolute, but subject to certain exceptions.[9] Thus, the court reasoned, a sale of assets pursuant to a Chapter 11 plan need not provide a secured creditor the right to credit bid in all situations.

Specifically, as a matter of law, the Third Circuit held that it is possible to provide indubitable equivalence to secured creditors through a public auction that prevents credit bidding and is effectuated under a Chapter 11 plan. However, at confirmation, a bankruptcy court would still have the opportunity to evaluate the outcome from such auction and determine whether the proceeds would in fact be the indubitable equiva-

lent of the secured lenders' claims. This gives a secured lender the opportunity in connection with confirmation to introduce evidence (*e.g.*, valuation testimony and analysis) as to why such lender is not receiving the indubitable equivalent of its collateral.

A further argument that was not advanced in *Philadelphia Newspapers*, but that could have been helpful to the secured lenders, is that disallowing credit bidding should be considered an improper exercise of a debtor's business judgment because it does not maximize value for the estate.[10] There is legitimate concern that the absence of credit bidding will leave an estate with the real possibility that the outcome of a debtor's auction undervalues the collateral sold. On appeal, such an argument would be subject to an abuse of discretion standard of review, unlike the Section 1129 of the Bankruptcy Code arguments in *Philadelphia Newspapers*, which were subject to *de novo* review, a higher standard.

The *Philadelphia Newspapers* dissent found that the three alternative clauses in Section 1129(b)(2)(A) are not options for a debtor to choose at will, but that the Bankruptcy Code can require a debtor to proceed under one clause or another "depending on how a given plan proposes to treat the claims of secured creditors."[11] For this finding, the dissent relied on the maxims that specific provisions prevail over general ones, and no part of a statute should be rendered superfluous.[12] Additionally, because the right to credit bid is preserved in other parts of the Bankruptcy Code, it should be preserved in cramdown as well.[13] Finally, the dissent found that the majority's decision was contrary to the settled expectations of borrowers and lenders, each of whom believes that lenders will be able to use credit bidding to protect against undervaluation of their collateral.[14]

ANALYSIS OF *RIVER ROAD*

In *River Road*, the Seventh Circuit, like the bankruptcy court, found the dissent from *Philadelphia Newspapers* to be more compelling than the majority opinion. Analyzing the plain meaning of the statute, the court found the text to be ambiguous as to whether a debtor may always

choose its preferred clause out of the three in Section 1129(b)(2)(A) of the Bankruptcy Code. Looking elsewhere in the Bankruptcy Code for guidance, the court noted that secured lenders are protected from undervaluation of their collateral in other contexts and reasoned that they should be afforded such protection in Section 1129(b)(2)(A) of the Bankruptcy Code as well.[15] Credit bidding provides such protection; without it, the price obtained at auction may be artificially low and it would be impossible to prove at plan confirmation that lenders had received the indubitable equivalent of their claims.[16] Such a plan would not be confirmable under 1129(b)(2)(A)(iii) because it only "*might* provide secured lenders with the indubitable equivalent of their claims."[17]

The court also determined that the debtors' interpretation would render portions of the statute superfluous because it would mean that plans of the types described in clauses (i) and (ii) but failing to meet the requirements of those clauses could still be confirmable under clause (iii), and there would have been no reason for Congress to include clauses (i) and (ii) in the statute.[18] Finally, the court pointed out that eliminating a secured creditor's right to credit bid in this situation would conflict with the Code's "interest in insuring that secured creditors are properly compensated," which is evident in other sections, such as Sections 363(k) and 1111(b).[19] Therefore, the court found that "the Code requires that cramdown plans that contemplate selling encumbered assets free and clear of liens at an auction [must] satisfy the requirements set forth in subsection (ii) of the statute."[20]

River Road emphasized protecting secured lenders against the potential for undervaluing their collateral if an auction does not provide for credit bidding. However, this decision was rendered in connection with arguments asserted by an undersecured creditor, and it is not clear whether the court would have reached the same outcome if such arguments were advanced by an oversecured creditor.

CONCLUSION

River Road establishes a circuit split over the issue of whether debtors may prohibit credit bidding in connection with asset sales that are conducted through Chapter 11 plans. As such, the issue may eventually be decided by the Supreme Court.[21] Nevertheless, it is good news for lenders as it provides a counterweight to *Philadelphia Newspapers* for debtors filing outside the Third Circuit.

NOTES

[1] *River Rd. Hotel Partners, LLC v. Amalgamated Bank (In re River Rd. Hotel Partners, LLC)*, --- F.3d ---, 2011 WL 2547615 (7th Cir. June 28, 2011) ("*River Road*").

[2] 599 F.3d 298 (3d Cir. 2010) ("*Philadelphia Newspapers*").

[3] *River Road* at *7.

[4] *Id.* at *8.

[5] Bankruptcy Code Section 1129(b)(2)(A) states that a plan is "fair and equitable," for purposes of the cramdown requirements of 1129(b)(1) as applied to a class of impaired secured creditors, if it provides:

> (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
>
> (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;
>
> (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
>
> (iii) for the realization by such holders of the indubitable equivalent of such claims.

11 U.S.C. § 1129(b)(2)(A).

[6] *In re River Rd. Hotel Partners, LLC*, 2010 WL 6634603 at *1 (Bankr. N.D.Ill. Oct. 5, 2010). The bankruptcy court also held that no specific facts of the case would justify denying the lenders' right to credit bid "for cause" under Section 363(k). *Id.* at *1-2.

[7] *Philadelphia Newspapers* at 302.

[8] *Id.* at 311.

[9] *Id.* at 316 (noting that that if the protections found in Sections 1111(b) and 363(k) of the Bankruptcy Code were absolute, they would afford "a special protection…to secured lenders to recognize some value greater than their secured claim," but holding that "a secured lender's expectation of benefitting from the eventual appreciation of collateral…is not an entitlement when the property is part of a bankruptcy estate.").

[10] In *Philadelphia Newspapers*, the bankruptcy court actually indicated that it thought the disallowance of credit bidding was an improper exercise of the debtor's business judgment, but the district court held such findings to be dicta based on an insufficient factual record that did not need to be afforded deference, and the Third Circuit declined to address the issue as its review was limited to legal questions. *See In re Philadelphia Newspapers, LLC*, 2009 WL 3242292, at *10 (Bankr. E.D.Pa. October 8, 2009); *In re Philadelphia Newspapers, LLC*, 418 B.R. 548, 566 n.19 (E.D.Pa. 2009); *Philadelphia Newspapers* at 318 n.16.

[11] *Philadelphia Newspapers* at 325.

[12] *Id.* at 328-331.

[13] *Id.* at 331-334.

[14] *Id.* at 336-337.

[15] *River Road* at *7 (noting the "incongruity" between auctions of the type the debtors proposed and "those recognized elsewhere in the Code," such as in Sections 363(k) and 1129(a)(2)(B)(ii)).

[16] *Id.* ("In essence, by granting secured creditors the right to credit bid, the Code promises lenders that their liens will not be extinguished for less than face value without their consent. This protection is important since there are number of factors [sic] that create a substantial risk that assets sold in bankruptcy auctions will be undervalued.").

[17] *Id.*

[18] *Id.* at *8 ("If, as the Debtors propose, Subsection (iii) permits a debtor to sell an asset free and clear of liens without permitting credit bidding, then it is

difficult to see what, if any, significance Subsection (ii) can have. Similarly, the Debtors' interpretation would permit properly-designed reorganization plans to sell encumbered assets without satisfying the conditions set forth in Subsection (i). We cannot 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 these requirements in a subsequent subsection.").

[19] *Id.*

[20] *Id.* at *9.

[21] On August 5, 2011, certain affiliates of River Road Hotel Partners, LLC filed a certiorari petition to appeal *River Road* to the Supreme Court, but the Suprme Court has not yet ruled on the petition.