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Can a Secured Creditor Be Denied the Right to Credit Bid When the Creditor's Collateral Is Sold Pursuant to a Chapter 11 Plan of Reorganization?

CASE AT A GLANCE

A bankruptcy plan can only be confirmed over the objection of a secured creditor if the plan is found to be "fair and equitable." The fair and equitable standard requires, at a minimum, that (i) the creditor may retain its lien on its collateral; (ii) the collateral will be sold subject to the creditor's right to credit bid its debt; or (iii) the creditor will receive the "indubitable equivalent" of its claim. The Supreme Court must decide whether a plan can provide for the sale of collateral without granting the creditor the right to credit bid (as required under clause (ii)) by providing the creditor with the proceeds of the sale as the "indubitable equivalent" of its claim, under (iii).

RadLAX Gateway Hotel, LLC v. Amalgamated Bank
Docket No. 11-166

Argument Date: April 23, 2012
From: The Seventh Circuit

by Marshall Tracht
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INTRODUCTION

In the past few years, courts have confirmed several Chapter 11 bankruptcy plans that provided for the sale of a secured creditor's collateral while expressly denying the secured creditor the right to credit bid at the sale. (Credit bidding is the ability of a secured creditor to purchase its collateral at auction by crediting the purchase price against the secured debt rather than paying cash. After all, if it paid cash, that cash would just be returned to the secured creditor as payment on its secured claim.) Debtors argue that the presence of a secured creditor who can credit bid discourages third parties from participating in the auction; creditors believe that the denial of their right to credit bid is an attempt to force them to take less than the full value of the collateral—in many cases through a low bid submitted by a purchaser related to or favored by the debtor. This case could be decided on narrow grounds of statutory interpretation, or be the occasion for serious consideration of the premises of bankruptcy law, mortgage law, and secured credit.

ISSUE

May a debtor confirm a Chapter 11 plan of reorganization under which it sells assets free of a lien without providing the secured creditor with the right to credit bid as specified in 11 U.S.C. § 1129(b)(2)(A)(ii), instead of providing the secured creditor with the proceeds of the sale as the "indubitable equivalent" of its claim under 11 U.S.C. § 1129(b)(2)(A)(iii)?

FACTS

The debtors, RadLAX Gateway Hotel, LLC, and RadLAX Gateway Deck, LLC, own the Radisson Hotel and a neighboring parking structure at the Los Angeles International Airport. In 2007, they obtained a $142 million construction loan from the lender, Ultra Construction Loan Investment Fund (for whom Amalgamated Bank serves as trustee and administrative agent). In 2008, the debtors defaulted on the loan, which then stood at $120 million and was secured by substantially all of the debtors' assets. During the bankruptcy case, the debtors arranged a sale of the assets for $47.5 million to a buyer linked to the debtors. The principal behind the debtors had an option to purchase equity in the purchaser, and the purchaser agreed to retain the existing management company, owned by the principal, if it acquired the project. The sale terms provided that the proceeds would be used to pay the debtors' financial advisers' fees and that the purchaser would provide a small share of profits for three years to fund some distribution to unsecured creditors. The remaining sale proceeds would go to the lender as payment on its construction loan.

The sale would be subject to higher offers at an open auction, but the contract with the buyer provided that the lender would not be permitted to credit bid. The debtors filed a plan of reorganization to conduct this auction and sale and then distribute the proceeds.

The lender objected, contending that the plan could not be confirmed because the lender had a right to credit bid at any sale of its collateral. The bankruptcy court agreed and held that the plan could not be confirmed. However, in light of two recent court of appeals decisions that had permitted similar plans (*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 bankruptcy court certified an immediate appeal to the Seventh Circuit. While the appeal was pending,

the lender moved for relief from the automatic stay so that it could foreclose on the project. Meanwhile, the purchaser increased its offer for the property to $55 million.

The Seventh Circuit affirmed the bankruptcy court's decision not to confirm the plan. It held that while the statutory provision at issue, § 1129(b)(2)(A), was not unambiguous, the better reading was that in any sale of collateral free and clear of liens the credit bidding rights of subdivision (ii) had to be applied, and the debtor could not avoid them by relying on subdivision (iii)'s alternative of providing the "indubitable equivalent" of the creditor's claim.

CASE ANALYSIS

A plan of reorganization can be confirmed if all classes of creditors consent to the plan, or can be confirmed over the objection of a class of creditors if certain requirements are met. One such requirement is that the plan be "fair and equitable" to any dissenting class of creditors. The Bankruptcy Code then provides that

> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> (A) With respect to a class of secured claims, the plan 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.

The debtors contend that because (i), (ii), and (iii) are joined by the word "or," the plan can be confirmed if any of them are met, and their plan satisfies the "indubitable equivalent" requirement of (iii). The lender contends, however, that while these are alternatives, the debtor must satisfy the *applicable* alternative, and that in any case where the property is being sold free and clear of liens, the applicable alternative is (ii). In turn, subdivision (ii) requires that the sale be "subject to section 363(k)," which provides that a creditor may credit bid with its debt if its collateral is sold.

Each side supports its claim with various canons of statutory construction. The debtors argue "or" is disjunctive, meaning that any of the three standards, alone, meets the requirement. Moreover, by saying that the plan must provide for one of these, the statute leaves it up to the plan proponent to decide which to satisfy. According to the debtors, the text of the statute is clear and unambiguous in saying that any of these alternatives can be used to meet the fair and equitable standard. This, the debtors argue, is consistent with the goal of promoting reorganization by permitting flexibility in plan drafting rather than requiring a single approach to protecting the rights of the secured creditor. Further, the debtors point out, the sale procedures do not prevent the secured creditor from bidding—they simply require that the secured creditor bid cash, just as any other bidder must. If the secured creditor wins the auction, the creditor will then receive its cash back in satisfaction of its claim.

The lender argues that the debtors' construction of the statute would allow subdivision (iii) to achieve an "end-run around the more specific, and more stringent, protections of clause (ii)." According to the lender, the debtors here are attempting to do precisely what is contemplated by subdivision (ii) (a sale free and clear of liens) without providing the protection specifically required by that subdivision (credit bidding).

The heart of the lender's argument, however, is not about how statutes should be read but about the overall scheme of the Bankruptcy Code in dealing with the rights of secured creditors. According to the lender, the code has been carefully designed to protect secured creditors from the undervaluation of their collateral. This is accomplished by numerous interrelated provisions that include the right to credit bid under § 363(k) if the property is to be sold free and clear of liens, and the right to retain its lien for the full amount of the debt if the collateral is otherwise retained by the debtor or transferred. According to the lender, the debtor's reading of § 1129 to permit a lender to be stripped of its lien exchange for the proceeds of sale, without the ability to credit bid, allows the court to compel the lender to accept less than the full value of its lien in violation of these carefully drawn protections. In particular, the lender notes that bankruptcy sales often do not result in full value being realized and that bankruptcy sale processes are susceptible to manipulation by the debtor to sell collateral for less than full value to a favored bidder (as in this case). According to the lender, the right to credit bid is the ultimate protection against this risk, and the ability to bid cash is not a satisfactory alternative because not all creditors can raise the cash, and those who can will incur substantial, and unnecessary, costs in doing so. (In its brief as amicus curiae, the United States points out that the government is a major secured creditor that is generally not able to bid in cash, so depriving it of the right to credit bid would preclude its participation in any auction.)

The debtors, in contrast, focus on the need of bankruptcy debtors for flexibility in designing a plan of reorganization that will preserve the company's value and the jobs of its employees. In their reading, the right to credit bid is not the only possible way to protect the rights of secured creditors; clause (iii), by guaranteeing a secured creditor the "indubitable equivalent" of its claim, satisfies any concerns about undervaluation of the secured claim. A restrictive reading of § 1129 is thus unnecessary, the debtors conclude, and inconsistent with the rehabilitative goals of the Bankruptcy Code.

SIGNIFICANCE

This case is being closely watched by bankruptcy practitioners because the right to credit bid is viewed by creditors as a fundamental protection of their economic interests against undervaluation by the courts and manipulation by borrowers. (The problem of skewing the sale process to favor an insider is obvious here and was perhaps even more blatant in the *Philadelphia Newspaper* case that the Third Circuit decided.) From the debtor's perspective, however, the creditor's ability to credit bid is an often insuperable barrier to sale or reorganization of the assets.

This case is in some ways less than ideal as a vehicle for resolving these issues because it is a single asset real estate case, rather than some more complex operating company. In bankruptcy cases of many operating companies, the outcome of the bankruptcy case determines if the company will continue in business, to the benefit of its employees, suppliers, and community. With single asset real estate, however, there is no question about these issues; the only question is who the owner of the asset will be. In the end, this particular case is more of a fight between the lender and the debtors' principal over the value of the asset rather than an attempt to "reorganize" a company. Moreover, in *RadLAX,* all of the debtors' assets have been pledged to one secured creditor. In other cases—where a secured creditor has a lien on a critical piece of equipment or property but there are also other secured creditors with liens on other assets, and perhaps assets that are unpledged and so available to fund a payout to unsecured creditors—the balance between the need to protect a secured creditor's rights and the need for flexibility in structuring a reorganization might appear very different.

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PREVIEW of United States Supreme Court Cases, pages 248–250.
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