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U.S. Supreme Court Upholds Right of Secured Creditors to Credit Bid Under Chapter 11 Plan

On May 29, 2012, the U.S. Supreme Court, in a unanimous decision, resolved a high-profile circuit split regarding the right of secured creditors to credit bid in an asset sale under a chapter 11 plan. In *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*,[1] the Court held that a debtor cannot deny a secured creditor the right to credit bid as part of a chapter 11 plan providing for the sale of assets free and clear of the secured creditor's liens on those assets. The decision is a resounding victory for secured creditors—one that eliminates a once significant threat to secured creditor rights in bankruptcy.

Credit Bidding in Bankruptcy

Credit bidding refers to the ability of a secured creditor to apply up to the full amount owed to that creditor as a bid in connection with an auction and sale of collateral encumbered by its liens. Credit bidding provides secured creditors with the option of taking possession of collateral rather than accepting sale proceeds from that collateral. Such flexibility may be especially crucial in the context of a severely distressed market environment, as sale prices often fail to properly reflect the real or expected future value of collateral.

In a chapter 11 case, sales of the debtor's property outside of the ordinary course of business are conducted through either a sale under section 363 of the Bankruptcy Code, or pursuant to a plan of reorganization. Under section 363(k), a secured creditor has the express right to credit bid in connection with a section 363 sale of property subject to the secured creditor's liens.[2] In the case of a sale pursuant to a chapter 11 plan, however, the circuit courts were split as to whether a debtor could sell its property free and clear of a secured creditor's liens without being required to provide the secured creditor with the opportunity to credit bid. Both the Third Circuit in *In re Philadelphia Newspapers, LLC*[3] and the Fifth Circuit in *In re Pacific Lumber Co.*[4] found that a debtor was permitted, pursuant to section 1129 of the Bankruptcy Code, to deny a secured creditor its right to credit bid as part of a sale under a chapter 11 plan. More recently, the Seventh Circuit in *In re River Road Partners, LLC*[5] disagreed with the Third and Fifth Circuits, finding that such a sale pursuant to a chapter 11 plan is not permitted under section 1129 of the Bankruptcy Code. The U.S. Supreme Court agreed to hear the RadLAX debtors' appeal.

Section 1129 of the Bankruptcy Code sets forth the requirements for chapter 11 plan confirmation. Among these requirements, in the event that a class of impaired secured creditors votes to reject a plan,[6] a chapter 11 plan can nevertheless be confirmed over the objection of the rejecting class (known as a "cramdown"). For a plan to be confirmed in the face of a rejecting class of secured

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[1] No. 11-166 (Argued April 23, 2012 – Decided May 29, 2012). Attorneys from Katten Muchin Rosenman LLP and Morrison Foerster LLP led the successful effort for the secured creditors in the case.

[2] Section 363(k) provides, "[a]t a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." 11 U.S.C. §363(k).

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

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

[5] *River Road Hotel Partners, LLC v. Amalgamated Bank (In re River Road Hotel Partners, LLC)*, 651 F.3d 642 (7th Cir. 2011). The appellant debtors were known as the RadLAX debtors.

[6] Generally, a class of secured creditors would likely vote to reject a plan that provided for the sale of encumbered property yet denied the creditors the right to credit bid on that property.

creditors, the plan must, among other requirements, satisfy the "fair and equitable" provisions of section 1129(b)(2)(A). Section 1129(b)(2)(A) sets forth three alternative methods for meeting the "fair and equitable" requirement with respect to a secured creditor: (i) a secured creditor must retain its liens, whether or not its collateral is sold; (ii) if the secured collateral is sold free and clear of the secured creditor's liens, the sale must be subject to section 363(k) (which, as noted above, provides the right of the secured creditor to credit bid); *or* (iii) the plan provides the secured creditor with the "indubitable equivalent" of its secured claim.[7]

At issue in *RadLAX* was whether a plan can be confirmed that provides for the sale of collateral without allowing a secured creditor to credit bid its claim by relying upon the third prong of the "fair and equitable" standard, the "indubitable equivalent" test, even though the text of the second prong expressly refers to a sale of a secured creditor's collateral and the third "indubitable equivalent" prong does not.

Background

The debtors in *RadLAX* owned and operated the InterContinental Chicago O'Hare Hotel and affiliated space and the Radisson Hotel at Los Angeles International Airport. In order to finance the construction of the hotels, the debtors borrowed a combined amount of nearly $300 million from lenders subject to blanket liens in favor of the lenders on the debtors' assets. As part of their chapter 11 plans, the debtors sought to sell substantially all of their assets, including the hotel projects, free and clear of the lenders' liens. Amalgamated Bank, in its capacity as agent, objected to the debtors' bid procedures, arguing that they impermissibly denied the lenders the right to credit bid. In reply, the debtors relied on the *Philadelphia Newspapers* and *Pacific Lumber* cases, arguing that the debtors' plans were confirmable because they satisfied section 1129, including the "fair and equitable" standard of 1129(b)(2)(A), because the debtors' plans provided the lenders with the "indubitable equivalent" of their secured claims by virtue of the allocation of sale proceeds to the lenders.

The Bankruptcy Court rejected the debtors' argument, holding that the debtors could not sell their assets free and clear of the lenders' liens under the "indubitable equivalent" prong of section 1129(b)(2)(A). Rather, any plan involving the sale of the lenders' collateral was required to satisfy section 1129(b)(2)(A)(ii), which provides that lenders have the right to credit bid under section 363(k). Through a certification process, the debtors were able to appeal the Bankruptcy Court's decision directly to the Court of Appeals for the Seventh Circuit.

The Seventh Circuit affirmed the Bankruptcy Court's decision and declined to follow the *Philadelphia Newspapers* and *Pacific Lumber* cases, holding that where a plan called for the sale of encumbered property free and clear of all liens, and where the "fair and equitable" standard must be satisfied, the requirements of subsection (ii) of section 1129(b)(2)(A) must be met.

U.S. Supreme Court Decision

Writing for the unanimous Court,[8] Justice Scalia affirmed the Seventh Circuit's decision, finding that in order for a debtor to sell property free and clear of liens under section 1129(b)(2)(A), it must satisfy the requirements of clause (ii), and that a debtor could not simply choose to invoke clause (iii) where the sale would violate clause (ii). The Court then explained that section 1129(b)(2)(A) should be read as setting forth three distinct provisions that may apply depending upon the treatment of the secured creditor's collateral under the chapter 11 plan. Two of the provisions (clauses (i) and (ii)) were specific, while the third (clause (iii)'s indubitable equivalent requirement) was general. "The structure here suggests . . . that (i) is the rule for plans under which a creditor's lien remains on the property, (ii) is the rule for plans under which the property is sold free and clear of the creditor's lien, and (iii) is a residual provision covering dispositions under all other plans. . . .Thus debtors may not sell their property free of liens under §1129(b)(2)(A) without allowing lienholders to credit-bid, as required by clause (ii)."[9]

The RadLAX debtors' interpretation of section 1129(b)(2)(A), "under which clause (iii) permits precisely what clause (ii) proscribes" was "hyperliteral and contrary to common sense,"[10] violating a well established canon of statutory construction which holds that

[7] 11 U.S.C. § 1129(b)(2)(A).

[8] The decision was 8-0 with Justice Kennedy taking no part in the case.

[9] *Id.* at 8.

[10] *Id.* at 5.

a general provision cannot be used to contradict a specific provision, but rather a specific provision should be construed as an exception to the general one.

Implications of *RadLAX*

The U.S. Supreme Court's decision conclusively neutralizes the risk that a secured creditor can be denied the right to credit bid under a chapter 11 plan which proposes to sell property subject to the creditor's lien, restoring the protections afforded to secured creditors that were lost in the Third and Fifth Circuits. In doing so, the Court's decision affirms the rule that a second creditor whose collateral is being sold in connection with a bankruptcy proceeding will have the right to credit bid at the sale, regardless of whatever such sale takes place as an asset sale under section 363 or pursuant to a plan of reorganization under section 1129.

For more information, please contact your Katten Muchin Rosenman LLP attorney, or any of the following members of our **Bankruptcy and Creditors' Rights** or **Distressed Debt and Claims Trading** practices.

Bankruptcy and Creditors' Rights

Karin H. Berg	312.902.5523	karin.berg@kattenlaw.com
Dustin P. Branch	310.788.4420	dustin.branch@kattenlaw.com
Jeff J. Friedman	212.940.7035	jeff.friedman@kattenlaw.com
Brian D. Huben	310.788.4771	brian.huben@kattenlaw.com
Thomas J. Leanse	310.788.4475	thomas.leanse@kattenlaw.com
Kenneth E. Noble	212.940.6419	kenneth.noble@kattenlaw.com
Matthew W. Olsen	212.940.6472	matthew.olsen@kattenlaw.com
Kenneth J. Ottaviano	312.902.5366	kenneth.ottaviano@kattenlaw.com
Bradley E. Pearce	704.344.3095	brad.pearce@kattenlaw.com
Peter A. Siddiqui	312.902.5455	peter.siddiqui@kattenlaw.com
John P. Sieger	312.902.5294	john.sieger@kattenlaw.com
James N. Truitt	212.940.6368	james.truitt@kattenlaw.com
Joshua Wayser	310.788.4715	joshua.wayser@kattenlaw.com
Kristin C. Wigness	212.940.6547	kristin.wigness@kattenlaw.com

Distressed Debt and Claims Trading

Noah Heller	212.940.6539	noah.heller@kattenlaw.com

Katten

Katten Muchin Rosenman LLP

www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK OAKLAND SHANGHAI WASHINGTON, DC