

## Circuit Court Sides With Secured Lender -- Holds Credit Bidding Too Important To Be Prohibited in Bankruptcy Sales, Even Those Under a Plan

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The United States Court of Appeals for the Seventh Circuit issued its much anticipated decision in *In Re River Road Hotel Partners, LLC*, \_\_\_ F.3d \_\_\_ (7th Cir., June 28, 2011). In the closely watched case, the Seventh Circuit declined to follow the Third Circuit's decision in *Philadelphia Newspapers*, 599 F.3d 298 (3d Cir. 2010), holding instead that secured lenders have the right to credit bid in "free and clear" asset sales where their liens are being stripped, whether those sales occur under section 363 of the Bankruptcy Code or under a chapter 11 plan. In so ruling, the Court described the right to credit bid codified in section 363(k) of the Bankruptcy Code to be an important and promised protection for lenders that is essential to prevent undervaluation of assets in bankruptcy cases. We previously wrote on the Philadelphia Newspapers decision and the issue of credit bidding in ["Reports Of Credit Bidding's Death Are Greatly Exaggerated"](#).

### Background

River Road Hotel Partners, LLC and its affiliates (collectively, the "Debtors") are owners and operators of the InterContinental Chicago O'Hare Hotel. The hotel, which opened in September 2008, suffered financial setbacks almost immediately as a result of the economic downturn which began in late 2008 and continued into 2009. Only several months after opening, the Debtors found themselves seeking millions of dollars of additional financing from their secured lender, Longview Ultra Construction Loan Investment Fund, to fund the completion of the hotel's restaurant and to pay general contractors and suppliers.

After the Debtors and Longview failed to come to terms on additional financing and with the capital markets unavailable during the financial crisis, the Debtors filed for bankruptcy in August 2009 in the Northern District of Illinois. Upon the filing date, the Debtors were indebted to Longview on a secured basis in the amount of approximately \$155 million.

Following the bankruptcy filing, the Debtors marketed their assets and ultimately agreed to a stalking-horse bid from a third-party purchaser in the amount of \$42 million. With Longview unresponsive of the sale, the Debtors structured the sale process under a plan of reorganization and sought approval of bid procedures that denied Longview the right to credit bid its claims for its collateral.

## Bankruptcy Code Provisions Implicated In This Decision

To determine whether the Debtors' bid procedures could be approved, the parties both cited section 1129 of the Bankruptcy Code which sets forth the requirements for confirmation of a chapter 11 plan. Under section 1129(b), the Bankruptcy Code permits confirmation of non-consensual plans (colloquially, "cramdown plans") where such plans do not unfairly discriminate against dissenting classes and treat dissenting classes fairly and equitably. With respect to a class of secured claims, a plan is only fair and equitable if it satisfies one of the following three requirements:

- it provides secured creditors the right to retain their liens on collateral and get deferred cash payments with a net present value of at least the allowed amount of the holders' secured claims;
- in connection with a "free and clear" sale subject to section 363(k) of the Bankruptcy Code, it provides that liens attach to the proceeds of the sale; or
- it provides secured creditors with the "indubitable equivalent" of their claims.

See 11 U.S.C. § 1129(b)(2)(A).

## The Bankruptcy Court Agrees With the Lender, Declines to Approve Bid Procedures For Sale Under Section 1129 Without Credit Bidding Right

The Debtors bid procedures took a page from a strategy that was successful employed by the debtors in the *Philadelphia Newspapers* chapter 11 case. Rather than demonstrating that cause existed to deny Longview the right to credit bid under section 363(k) of the Bankruptcy Code, the Debtors argued that section 363(k) of the Bankruptcy Code did not apply at all, because they intended to cramdown their plan on Longview under Subsection (iii) of 1129(b)(2)(A) by arguing that the sale proceeds were the "indubitable equivalent" of its claims.

In *Philadelphia Newspapers*, the Third Circuit permitted the debtors to go forward with a similar sale that did not provide secured lenders the right to credit bid on the basis that section 1129(b)(2)(A), which is written in the disjunctive, provides debtors with alternative paths to seek confirmation of a chapter 11 plan. In that case, the Third Circuit found that since Subsection (iii) -- the indubitable equivalent prong -- does not refer to section 363(k), it was at least *theoretically* possible for a debtor to sell its assets under a chapter 11 plan without affording secured creditors the right to credit bid and to then seek confirmation of such plan on the basis that the proceeds of such sale constitute the "indubitable equivalent" of the lender's claim. The Third Circuit Court of Appeals, however, left undetermined whether such a plan would ultimately satisfy the indubitable equivalent standard. In its ruling, the Third Circuit referred to other consistent decisions *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir 2009) and *In re CRIMMI MAE, Inc.*, 251 B.R. 796 (Bankr. D.Md. 2005).

Longview objected to the Debtors' bid procedures and argued that "free and clear" assets sales, such as the one proposed by the Debtors, could only proceed pursuant to Section 1129(b)(2)(A)(ii), which specifically refers to section 363(k) of the Bankruptcy Code. Longview's argument was based upon the strongly-worded dissent of Judge Ambro in *Philadelphia Newspapers*, who argued that the 3-prongs in section 1129(b)(2)(A) were meant by Congress to be exclusively applicable by their terms to different types of plans, and not alternative paths available to debtors at their whim. Any other reading, according to Judge Ambro as echoed by Longview, would allow the more general Subsection (iii) to subsume the more specific Subsections (i) and (ii) and would make those two provisions superfluous.

The Bankruptcy Court agreed, finding no cause existed to deny Longview its right to credit bid. In so doing, the Bankruptcy Court declined to apply *Philadelphia Newspapers* (and other similar cases), finding Judge Ambro's dissent to be better reasoned.

The Debtors appealed and the Bankruptcy Court certified the appeal directly to the Seventh Circuit.

### **The Seventh Circuit Affirms the Bankruptcy Court**

On June 28, 2011, the Seventh Circuit affirmed the Bankruptcy Court's decision. Therefore, in the first circuit decision to take up credit bidding under a chapter 11 plan since *Philadelphia Newspapers*, the Seventh Circuit sided with Judge Ambro's dissent, finding it, and not the majority opinion, to be "compelling."

The Appellate Court's decision turned on both statutory construction and its own notions of the shortcomings of the bankruptcy process. Simply stated, in analyzing the text of section 1129(b)(2)(A), the Appellate Court agreed that reading the statute in the alternative would make the two first Subsections superfluous, a result that violated a cardinal rule of statutory construction. The Court also found that in all other instances where the Bankruptcy Code refers to "free and clear" sales, it also always refers to section 363(k) and the right to credit bid. Therefore, putting section 1129(b)(2)(A)'s inherent ambiguity into context, the Appellate Court found it more likely that Congress intended all asset sales that seek to strip liens to proceed under Subsection (ii) of 1129(b)(2)(A), with secured creditors getting the right to credit bid, absent a showing of cause.

Moreover, the Seventh Circuit found it dubious that a plan based on a "free and clear" asset sale that did not provide lenders the right to credit bid could ever be considered by any court "fair and equitable." The Court noted that the term "indubitable equivalent" is not defined in the Bankruptcy Code and that its definition depends in each case on the amount of the creditor's liens and the current value of the secured asset in question. Finding bankruptcy sales inherently unreliable, the Court was skeptical that a winning bid at a bankruptcy auction could serve as an effective determinate of market value. Rather, it was the lender's right to credit bid that served as the "crucial check against undervaluation." Without that right, the Court found no way to ensure that creditors are properly compensated as required by the Bankruptcy Code in connection with confirmation of a plan.

**Take Aways**

Given the continued softness in the credit markets, credit bidding is likely to remain an important tool for financial players in the distressed community, leading more courts to have to address similar issues. The *River Road* decision presents a forceful defense of the right to credit bid in asset sales under a chapter 11 plan, a right that is essentially inviolate in Section 363 sales outside of a plan. It also stems the tide of decisions permitting lien and rights stripping of secured creditors. Careful attention should be paid to the various jurisdictions where these sorts of debtor cases are filed, in order to ensure that secured creditors' rights are fully protected.