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# It's Indubitable: Supreme Court Upholds Secured Creditors' Unequivocal Right to Credit Bid at Plan Sales

***By Nathan P. Lebioda***

Much to the anticipation of the bankruptcy community, on May 29, 2012 the Supreme Court of the United States issued a decision in RadLAX Gateway Hotel, LLC v. Amalgamated Bank and put an end to the split among the Circuit Courts of Appeal on the issue of whether a secured creditor has the right to credit bid its claim when its collateral is being sold pursuant to a plan of reorganization.[1] Writing for a unanimous Court,[2] Justice Scalia found RadLAX to be "an easy case" and, in 10 succinct pages, definitively established that a secured creditor must be afforded its right to credit bid on collateral that a debtor proposes to sell free and clear of the creditor's liens pursuant to a cramdown plan of reorganization.

## What is Credit Bidding?

Significant asset sales by a debtor subject to a chapter 11 bankruptcy case can be effectuated either by a sale of assets outside the ordinary course of business under section 363 (a "363 Sale") of title 11 of the United States Code (the "Bankruptcy Code") or pursuant to a confirmed plan of reorganization (a "Plan Sale"). Both 363 Sales and Plan Sales are typically subject to a competitive auction mechanism to increase the likelihood that the debtor receives the maximum value for the asset. When property of a debtor that secures indebtedness is proposed to be sold through a 363 Sale, the secured creditor is given a statutory right to bid the face value of its allowed secured claim at the auction. Specifically, section 363(k) provides:

> At 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.

Although a secured creditor's right to credit bid in a 363 Sale has long been undisputed, when the collateral is being sold pursuant to a Plan Sale, Circuit Courts have questioned a secured creditor's right to credit bid. While section 363 of the Bankruptcy Code provides a direct right for a credit bid in a 363 Sale, a secured creditor's right to credit bid in a Plan Sale arises from a circuitous statutory scheme – known as "cramdown" – that allows a debtor to confirm a plan of reorganization (including one that mandates the sale of collateral) over the objection of a nonconsenting unimpaired class of creditors.[3] Section 1129(a) of the Bankruptcy Code specifies the statutory requirements a debtor must satisfy in order to confirm a plan of reorganization. One such requirement is that impaired classes of creditors must vote to accept the plan; however, this requirement can be avoided and the plan "crammed down" on the nonconsenting class if the debtors are able to show that the plan does not

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[1] RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 566 U.S. ___ (2012).

[2] Justice Kennedy took no part in the RadLAX decision.

[3] See 11 U.S.C. § 1126(b).

discriminate unfairly and is fair and equitable with respect to such class. Specifically, pursuant to section 1129(b)(2)(a) of the Bankruptcy Code, a debtor’s plan of reorganization is deemed “fair and equitable” and can be confirmed over the objection of a secured creditor whose collateral is proposed to be sold pursuant to a Plan Sale if the plan of reorganization 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;
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> (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.

In other words, a debtor’s proposed plan of reorganization is statutorily deemed to be “fair and equitable” to an objecting class of secured creditors as long as those creditors are provided one of the following: (1) replacement liens and repayment over time at market rates based on a judicially determined value of the collateral; (2) an opportunity to credit bid their claim at a sale of the collateral; or (3) the “indubitable equivalent” of their claim. While a secured creditor’s right to credit bid was traditionally applied to all cramdown Plan Sales, the Fifth and Third Circuit Courts of Appeal uprooted this tradition by permitting Plan Sales to go forward without permitting a credit bid, relying, instead, on the indubitable equivalent prong of the cramdown standard.[4] The problem is, “indubitable equivalent” is not a defined term in the Bankruptcy Code.

## Why is the Right to Credit Bid Important?

The section 363(k) right to credit bid is one of the fundamental protections afforded a secured creditor under the Bankruptcy Code. It is a direct mechanism to increase the likelihood that a secured lender receives the proper valuation of its collateral in a bankruptcy proceeding. Armed with the ability to credit bid up to the face amount of its allowed claim, a secured creditor would not rationally outbid another cash bidder unless the secured lender believed it could generate a future return on the collateral in excess of the present cash proceeds of the sale derived from the other cash bidder. Conversely, if a cash bidder believed that a secured creditor was attempting to acquire the collateral below market value through its credit bid in hopes of retaining the future upside potential, that cash bidder would presumably make a cash bid exceeding the credit bid.[5]

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[4] See In re Pacific Lumber Co., 584 F.3d 229 (5th Cir. 2009) (holding that cramdown plan was confirmable notwithstanding the lack of a credit bid because the three prongs of “fair and equitable” test should be read as alternatives and could be satisfied if the creditors received the “indubitable equivalent” of their secured claim); In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. 2010) (holding that the “indubitable equivalent” prong does not itself require allowing secured creditors to credit bid their claims).

[5] This reasoning, however, ignores several critical variables in a restructuring that would rationalize bidding above the market value of the collateral, including the value of any tag-along control rights or other participations that flow from ownership of the debt.

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## Credit Bidding in RadLAX

In RadLAX, both the Bankruptcy Court and the United States Court of Appeals for the Seventh Circuit – after a direct appeal from the Bankruptcy Court – declined to follow Pacific Lumber and Philadelphia Newspapers and instead denied the debtors' proposed bidding procedures for the Plan Sale of collateral that did not provide the agent of a $142 million prepetition secured loan a right to credit bid its claim. Rather, the secured creditor would be required to bid with cash at the auction against a stalking horse bidder who ultimately offered $55 million for the collateral. The debtors contended that the treatment proposed under the plan – the liens of the secured creditors attaching to the cash proceeds derived from the auction of the collateral – constituted the indubitable equivalent of their claim and, *inter alia*, was "fair and equitable" for purposes of satisfying the Bankruptcy Code's cramdown requirements.

## The Court's Decision

In an 8-0 opinion decided little more than a month after oral arguments, the Court relied on the basic canon of statutory construction that "the specific governs the general."[6] Recognizing that the canon typically applies to situations that create *contradictory* results, the Court found the canon to be equally applicable in situations, like credit bidding in Plan Sales, to avoid "the *superfluity* of a specific provision that is swallowed by the general one . . . ."[7] This reasoning was foreshadowed by Justice Scalia at oral argument:

> [D]oes it make much sense for a provision to say you can do it three ways: number (i); number (ii), you can have this sale subject to credit bidding; and number (iii), after – after saying that, specifically, oh, you can have this sale, not subject to credit bidding? That's -- that's not a very sensible statute. Why – why go through that – that problem of – of saying number (ii), if you could have left it to number (iii) anyway?[8]

Although the general/specific canon is not absolute, the debtors failed to make the requisite showing that textual indications in the statute necessitate the opposite outcome, namely that the specific provision embraced by a general one is not superfluous because it creates a safe harbor.[9] The debtors did, however, argue that the first two prongs of the "fair and equitable test" – retention of liens plus future cash payments or a collateral sale subject to a credit bid – do constitute *ipso facto* safe harbors that always constitute the "indubitable equivalent" of a secured claim in satisfaction of the third prong.[10] The Court, however, rejected the argument, stating that such a result would "normally be achieved by setting forth the 'indubitable equivalent rule first (rather than last), and establishing the two safe harbors as provisos to that rule."[11] Ultimately, the Court ruled "as a matter of law, *no* bid procedures [that failed to provide a secured creditor with a 363(k) credit bid right] could satisfy the fair and equitable test required to confirm a cramdown plan of reorganization.[12]

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[6] RadLAX, 566 U.S. at 5 (emphasis added) (citing Morales v. Trans World Airlines, Inc., 504 U.S. 374, 384 (1992)).
[7] Id. at 6.
[8] Transcript of Oral Argument at 14:10-19, RadLAX, 566 U.S. ____ (2012).
[9] Id. at 7.
[10] Id.
[11] Id.
[12] Id. at 9 (emphasis added).

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## Implications

Prior to RadLAX, the secured lending community found ways to work around a bankruptcy court's refusal to provide a right to credit bid by, among other ways, providing an absolute right to credit bid in DIP and cash collateral orders. Additionally, because a secured creditor's lien attaches to the cash proceeds of an auction, secured creditors have successfully submitted cash bids for assets and, in turn, received the very same cash proceeds to pay down their prepetition debt. However, this workaround to a credit bid denial was often difficult to implement. For instance, a secured lending syndicate could have difficulty apportioning and collecting the necessary cash for a bid, especially if certain members of the syndicate refuse to put up cash for a bid. Additionally, there remains the risk that the debtor's plan of reorganization that governs the secured lender's treatment is never confirmed (or the confirmation delayed). In such a situation, the secured lender has already made a cash outlay for its own collateral and the cash is now locked in the estate, subject to the plan confirmation process. Additionally, Justice Scalia expressly recognized the problem with such a workaround in situations where the secured creditor was the Federal Government.[13]

With the credit bid right definitively established as one that exists in both the 363 Sale and Plan Sale contexts, secured creditors are now afforded a mechanism to minimize the potential for a debtor to liquidate collateral at depressed prices. However, secured creditors can expect debtors' counsel to craft creative arguments to support denial of a secured creditor's credit bid right "for cause" as expressly contemplated by section 363(k) of the Bankruptcy Code, an area with little developed case law and plenty of room for judicial manipulation when coupled with the broad equitable powers given to a bankruptcy court under section 105(a) of the Bankruptcy Code.

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[13] See RadLAX, 566 U.S. at 4 n.2 ("That right [to credit bid] is particularly important for the Federal Government, which is frequently a secured creditor in bankruptcy and which often lacks appropriations authority to throw good money after bad in a cash-only bankruptcy auction.").