Client Alert.

May 29, 2012

Supreme Court Resolves Conflict in Circuit Courts Regarding Credit Bidding

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On May 29, 2012, the United States Supreme Court resolved a split among the federal courts of appeals on an important bankruptcy issue, agreeing with arguments Morrison & Foerster advanced on behalf of Amalgamated Bank. In a unanimous opinion in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*,[1] the Court held that a Chapter 11 plan of reorganization that provides for a sale of a secured creditor's collateral free and clear of liens must afford that secured creditor the right to credit bid. The decision is significant because it allows a secured creditor to protect the benefit of its bargain to either be repaid in full or take possession of its collateral, by preventing the debtor from stripping the creditor's lien for an amount at less than the creditor thinks the property is worth.

BACKGROUND

At the height of the last economic bubble, Amalgamated Bank and its co-lender ("the Lenders") made loans to two related sets of debtors that separately owned two hotels and related properties. The properties and related assets secured the loans, which exceeded $300,000,000 in total. By 2009, the debtors were unable to make their loan payments; they filed voluntary Chapter 11 petitions under the Bankruptcy Code on August 19, 2009. By that time, the value of the Lenders' collateral had dropped far below the debt it secured. Thus, there were no unencumbered assets in the debtors' estates from which to pay unsecured creditors without the Lenders' consent.

In the summer of 2010, the debtors proposed reorganization plans that provided for a sale at auction of their assets to a "stalking horse" bidder or a successful over-bidder free and clear of the Lenders' liens, with the liens transferred to the proceeds of the sale. The plans included proposed bidding procedures for the auction that would have, among other things, precluded the Lenders from credit bidding their claims, requiring instead that all bids be cash bids. The debtors based this feature of their plan on the holdings of the United States Court of Appeals for the Third Circuit in *In re Philadelphia Newspapers, LLC*,[2] which approved such bidding procedures for a plan sale free and clear, and the United States Court of Appeals for the Fifth Circuit in *Scotia Pacific Co. v. Official Committee of Unsecured Creditors (In re Pacific Lumber Co.)*.[3]

The Bankruptcy Court considered the credit bidding procedures first. The Lenders objected to being denied the right to credit bid on various grounds. The Bankruptcy Court sustained their objections, and after a rare direct appeal by the debtors, the Seventh Circuit affirmed in *River Road Hotel Partners, LLC v. Amalgamated Bank (In re River Road Hotel Partners, LLC)*[4]. Just a few days later, the Lenders confirmed their own plan of reorganization with respect to one of the hotels, leaving the RadLAX debtors as the only debtors to whom these rulings remained relevant.

[1] No. 11-166.

[2] 599 F.3d 298 (3d Cir. 2010).

[3] 584 F.3d 299 (5th Cir. 2009).

[4] 651 F.3d 642 (7th Cir. 2011).

The Supreme Court granted the RadLAX debtors' petition for certiorari on December 12, 2011. The question before the Court was whether a debtor could confirm a cramdown plan using the "indubitable equivalent" standard of clause (iii) of Section 1129(b)(2)(A) as an end run around the credit-bidding requirements of clause (ii) of that subsection. The Court heard oral argument on April 23, 2012.

THE SUPREME COURT'S DECISION

By a vote of 8-0, the Supreme Court affirmed the rulings below.[5] Justice Scalia, writing for the Court, reasoned that Section 1129(b)(2)(A) of Chapter 11 provides three distinct routes to confirm a plan over the objection of the secured creditor, depending on how the plan proposes to treat the collateral. Clause (i) applies when the secured creditor retains its lien on the property and receives deferred cash payments. Clause (ii) applies when the property is to be sold free and clear of the lien and the secured creditor is to receive the proceeds of the sale, but requires that the creditor, in the absence of cause, be allowed "to credit bid at the sale, up to the amount of its claim."[6] And under clause (iii), the plan must provide the secured creditor with the "indubitable equivalent" of its claim.

As the Court explained, "[t]he debtors in this case have proposed to sell their property free and clear of the Bank's liens, and to repay the Bank using the sale proceeds—precisely, it would seem, the disposition contemplated by clause (ii)."[7] Yet the debtors sought to do so without allowing credit bidding; instead, they claimed "their plan can satisfy clause (iii) by ultimately providing the Bank with the 'indubitable equivalent' of its secured claim, in the form of cash generated by the auction."[8] The Court rejected that reading as "hyperliteral and contrary to common sense."[9]

Agreeing with arguments advanced by Morrison & Foerster, the Court held that the specific provision of clause (ii) governed over the more general provision of clause (iii). Justice Scalia explained: "clause (ii) is a detailed provision that spells out the requirements for selling collateral free of liens, while clause (iii) is a broadly worded provision that says nothing about such a sale."[10] Clause (iii) is merely "a residual provision covering dispositions under all other plans—for example, one under which the creditor receives the property itself, the 'indubitable equivalent' of its secured claim."[11] As such, the Court held, 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)."[12]

SIGNIFICANCE

The importance of the *RadLAX* decision is that it protects secured creditors from undervaluation of their collateral in reorganization plans by closing the loophole opened by *Philadelphia Newspapers* and *Pacific Lumber*. Under the interpretation of those cases, a secured creditor that lacks the cash to bid at a plan sale free and clear faces the prospect of a stalking horse bidder or other over-bidder winning the auction sale at a price that is below the real value of the collateral, leaving the secured creditor to the vagaries of judicial valuation of the collateral as to whether the sale produced

[5] Justice Kennedy took no part in the decision.

[6] Slip op. 4.

[7] *Id.* at 5.

[8] *Id.* at 5.

[9] *Id.* at 5.

[10] Slip op. 7.

[11] Slip op. 8.

[12] *Id.* at 8.

the "indubitable equivalent" of the secured creditor's claim. When collateral is undervalued through that process, value is shifted from the secured creditor to the buyer without compensation to the former. Given the Supreme Court's ruling, this strategy is no longer available to debtors.

A team of Morrison & Foerster lawyers successfully represented Amalgamated Bank as agent for the secured Lenders. The team consisted of Deanne Maynard, Chair of the firm's Appellate and Supreme Court Group, who argued the case in the Supreme Court; Brian Matsui and Marc Hearron, also of the Appellate and Supreme Court Group, and Adam Lewis, Norman Rosenbaum, John Pintarelli, and Erica Richards of the firm's Bankruptcy and Restructuring Group, which had prevailed on the issue in the Bankruptcy Court for the Northern District of Illinois and United States Court of Appeals for the Seventh Circuit.

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