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Credit Bidding in Chapter 11 – Where We Are Now

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A secured creditor's option to credit bid its claim where its collateral is to be sold under a chapter 11 plan is an important protection to ensure that the creditor's collateral is not sold for less than its actual value. Rather than accepting the cash generated by a low bid, the creditor can submit its own bid, up to the amount of its secured claim, and recover its collateral instead. This traditionally recognized right was upset by two fairly recent circuit court decisions, one from the Fifth Circuit and one from the Third Circuit. In re Pacific Lumber Co., 584 F.3d 229 (5th Cir. 2009); *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010). In each case, the circuit court analyzed section 1129(b)(2)(A) and found that a secured creditor does not have an absolute right to credit bid its claim in the context of a chapter 11 plan. Subsequently, in June of 2011, the Seventh Circuit analyzed section 1129(b)(2)(A) to address the same issue, but expressly upheld a secured creditor's right to credit bid. The Seventh Circuit's decision created a circuit split that exists today, and that will potentially be heard by the United States Supreme Court.

Section 1129(b)(2)(A)

At issue in both *Pacific Lumber* and *Philadelphia Newspapers* was the interpretation of section 1129(b)(2)(A) of the Bankruptcy Code. Section 1129(b)(2)(A) establishes standards for determining whether a chapter 11 plan meets the confirmation requirement that it be "fair and equitable" with respect to secured claims. Satisfaction of any one of three listed subsections will permit confirmation. To summarize, the three subsections require that under the plan: (i) the secured creditor retains its lien to the extent of its allowed secured claim and receives deferred cash payments totaling at least the allowed amount of the claim; (ii) if the secured creditor's collateral is sold, the sale allows for credit bidding and liens attach to the proceeds of the sale; or (iii) secured creditors realize the "indubitable equivalent" of their secured claims.

The Pacific Lumber Case

In September of 2009, the Fifth Circuit issued its decision in *Pacific Lumber*, which upheld a chapter 11 plan that did not permit secured creditors to credit bid in connection with the sale of their collateral. *Pacific Lumber Co*., 584 F.3d 229 (5th Cir. 2009). Rather, the plan provided a cash payment to the secured creditors

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based on the judicially determined value of their collateral. The court determined that section 1129(b)(2)(A)(ii), which incorporates credit bidding, is not the exclusive means to accomplish plan confirmation where a secured creditor's collateral is to be sold as part of the plan. Alternatively, the court found, a plan could provide the creditor the "indubitable equivalent" of its claim under 1129(b)(2)(A)(iii) by providing the secured creditors with cash in the amount of the judicially determined value of their collateral.

The Philadelphia Newspapers Case

Philadelphia Newspapers involved a chapter 11 plan that proposed to sell substantially all of the debtor's assets free and clear of the liens of existing secured creditors. The stalking horse bidder was an entity formed by equity holders of the debtor, with an initial bid amount that was significantly less than outstanding secured claims. The secured creditor sought to credit bid its secured claim, but the debtor objected based on the auction procedures, which required an all-cash bid. The secured creditor took the position that pursuant to section 1129(b)(2)(A)(ii) of the Bankruptcy Code, it had the right to credit bid and the debtor took the position that the plan was fair and equitable under section 1129(b)(2)(A)(iii) because the secured creditor would receive the "indubitable equivalent" of its claim in the form of the cash proceeds from the auction. The bankruptcy court denied the debtor's requested bidding procedures and determined that the secured creditor was entitled to credit bid. The district court reversed, and the Third Circuit affirmed the district court's decision, finding that the "indubitable equivalent" requirement in section 1129(b)(2)(A)(iii) does not require that a secured creditor be permitted to credit bid.

Ultimately, secured creditors could respond to the *Pacific Lumber* and *Philadelphia Newspapers* cases by obtaining financing for the cash purchase of their assets. Because liens attached to the proceeds of the collateral in the same order of priority, the secured creditor would recover most of the purchase price to apply toward its outstanding claim, putting the creditor in essentially the same position as if it had credit bid. However, where a secured creditor is unwilling or unable to come up with a cash bid, limitations on credit bidding are concerning.

The River Road Hotel Partners Case

The *Philadelphia Newspapers* and *Pacific Lumber* decisions were troubling from a secured creditor's perspective because they raised concern that debtors or other

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interested parties could undermine the secured creditor's interest by proposing plans that disallowed credit bidding. However, the Seventh Circuit recently issued a decision creating a circuit split. In June of 2011, the Seventh Circuit determined that a secured creditor has an absolute right to credit bid in the context of a sale under a chapter 11 plan. *River Rd. Hotel Partners, LLC v. Amalgamated Bank*, 2011 U.S. App. LEXIS 13131 (7th Cir. Ill. June 28, 2011). In *River Road*, the debtors filed chapter 11 plans that proposed to sell all of their assets by auction. The stalking horse bids were significantly less than the amount of secured claims encumbering the assets to be sold. The secured creditor objected to the sale, asserting its right to credit bid. The bankruptcy court rejected the debtors' bid procedures, recognizing the secured creditor's right to credit bid. An appeal was taken directly to the Seventh Circuit. The Seventh Circuit stated that "because the debtors' proposed auctions would deny secured lenders the ability to credit bid, they lack a crucial check against undervaluation." The Seventh Circuit recognized that there is an increased risk that the winning bids would not provide the lenders with the current market value of their collateral. The court concluded that "a plain-meaning reading of Subsection (iii)'s text does not establish that it can be used to confirm plans that propose auctioning off a debtor's encumbered assets free and clear of liens without allowing credit bidding."

On August 5, 2011, the debtors filed a petition for a writ of certiorari with the United States Supreme Court, stating that "this case involves perhaps the most hotly-debated issue of bankruptcy law today." Petitioner Motion p. 3. Two amicus curiae briefs have been filed in support of the motion; both briefs support credit bidding and seek Supreme Court resolution of the dispute. *See Brief amici curiae of Bankruptcy Scholars, filed Sept. 8, 2011, and Brief amicus curiae of Loan Syndications and Trading Association, filed Sept. 9, 2011*. According to the Supreme Court's docket, the lenders have until October 11, 2011 to file their response. If the Supreme Court takes up the issue, its ultimate decision could have profound effects on the rights of secured creditors in chapter 11 and the ultimate bargaining power of all stakeholders in a chapter 11 case.

Please contact your Reinhart attorney or any attorney in Reinhart's Business Reorganization Practice Area if you have any questions concerning credit bidding in Chapter 11.

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