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Supreme Court Holds that Free and Clear Sale Plan Cannot be Confirmed Without Preserving Secured Creditor's Credit Bidding Rights

On May 29, 2012, the Supreme Court in *In RadLAX Gateway Hotel, LLC* ("RadLAX") held that a Chapter 11 reorganization plan that proposes the sale of encumbered assets free and clear of liens must honor the secured creditor's right to credit bid its claim in order to be confirmed under the "fair and equitable" standard of the Bankruptcy Code. In so doing, the Supreme Court affirmed the view of the Seventh Circuit and rejected the views of the Third and Fifth Circuits that debtors could use the vague "indubitable equivalence" standard of the third subsection of the secured creditor cram down provision (section 1129(b)(2)(A)(iii)) to circumvent the express grant of credit bidding rights in the second subsection (section 1129(b)(2)(A)(ii)).

Although the Courts of Appeal struggled with the issue and disagreed about the proper approach to credit bidding, the Supreme Court had little difficulty deciding the case. Justice Scalia, writing for an unanimous 8-0 Court (with Justice Kennedy abstaining), delivered a short 12-page opinion that characterized this as "an easy case" from a statutory interpretation standpoint. The Supreme Court found the debtor's reading of section 1129(b)(2)(A), under which the general clause (iii) would permit precisely what clause (ii) prohibits, "to be hyperliteral and contrary to common sense."

Applying the well-known statutory construction canon that the "specific governs the general," the Supreme Court found that "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." As such, the Supreme Court held that if a debtor sells encumbered assets free and clear of liens pursuant to a plan, it must recognize the secured creditor's right to credit bid on those assets. In reaching its conclusion, the Supreme Court declined to consider the policy arguments with respect to credit-bidding, concluding that "the pros and cons of credit-bidding are for the consideration of Congress, not the courts."

The decision is a victory for secured lenders, particularly mortgage lenders in single asset real estate cases, although it does not guaranty lenders the right to credit bid in every situation, and the Bankruptcy Code does still provide debtors with other mechanisms to seek to retain underwater collateral. At the same time, a contrary ruling would have exposed secured lenders to the uncertainty of a judicial valuation of their collateral in a plan asset sale context. Under the "indubitable equivalent" standard, as interpreted by the Third Circuit in *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010), a plan could provide for a sale of a secured creditor's collateral free of its lien if the bankruptcy judge determined that the sale price represented the value of the collateral, while denying the secured creditor the right to credit bid.

The Third Circuit's approach allowed a debtor to manipulate the sale terms and procedures to steer the sale toward a favored bidder, often an insider, at a below market price. The ability to credit bid protected creditors from this risk by allowing secured creditors to avoid a below-market judicial determination by bidding in its claim until the sale price exceeds the amount it is owed or until the competing bids reach the level of what the secured creditor believes to be the market value of the collateral. In theory other mechanisms, such as a creditor making a similar cash bid with the cash coming back to the creditor after the sale as proceeds of its collateral, would still have been available to creditors. Those mechanisms, however, are often impractical for creditors. For example, in a syndicated or securitized loan, credit-bidding is often possible while there may be no mechanism to obtain the necessary cash to make a bid. And, as the Supreme Court noted in its opinion, the federal government is frequently a secured creditor, but lacks appropriations authority to make cash bids in a bankruptcy auction.

The right to credit bid is also important to a secured creditor who is under-secured but believes that the collateral's value is only temporarily depressed. Because its claim exceeds the current market value of the collateral, the creditor can use its credit-bidding right to out bid other market-driven bidders and become the owner of the collateral. This allows the lender to capture any future increase in value. Credit-bidding is also an important tool for the acquisition of assets held by bankruptcy debtors. A potential acquirer might purchase the secured debt at a substantial discount, but then be able to acquire the asset in bankruptcy by bidding the face amount of the debt.

Although the credit bidding issue has been the subject of much attention recently at bankruptcy conferences and in trade publications, the Court's holding does not mean that lenders are protected in all circumstances, and debtors still have options to seek to limit a lender's ability to credit bid in certain circumstances. First, there is still no absolute right to credit bid. As the Supreme Court noted, the statute allows the bankruptcy court to deny credit bidding for "cause." If the possibility of a credit bid will deter other market-based bidders and chill the sale, a bankruptcy court might deny the lender the right to credit bid. Or, in a case where the collateral is only one of several assets being sold as a package, or where there are first and second lien creditors, the bankruptcy court might deny the right to credit bid. Thus, the Supreme Court's opinion only prevents the debtor from denying credit bidding in those cases where there is no good reason for seeking to deny the right. Because such cases in which credit bidding is denied for "cause" likely would be rare, *RadLAX* deprives the debtor of that unilateral option and thus shifts the negotiation dynamic in favor of secured creditors. This is particularly true in single asset real estate cases because the debtor will have difficulty establishing "cause" for denying credit bidding.

In addition, debtors still have the ability to seek to retain underwater collateral through an equity recapitalization, in which the secured creditor's debt is crammed down and restructured consistent with the requirements of Section 1129(b)(2)(A)(i), based upon a judicial valuation of the collateral, without the secured creditor necessarily having any right to obtain a market valuation or offer a competing equity bid. When existing equity is providing the funding for the equity recapitalization, the Supreme Court's ruling in *In re: 203 North LaSalle* requires either competing plans or competitive bidding, but the secured lender would not necessarily have any right to credit bid for the equity.

While *RadLAX* involved the free and clear sale provisions of section 1129(b)(2)(A)(ii), it may have greater legal significance in cases where the debtor wants to keep the collateral. The Supreme Court's reasoning that the general "indubitable equivalence" test in clause (iii) could not be applied to situations addressed by a more specific section should apply with equal force to the asset retention cram down provision of clause (i). That provision requires that the secured creditor retain its lien and limits the debtor's discretion in structuring the revised repayment terms. Presumably, after *RadLAX*, debtors will be limited to the parameters of clause (i) and

cannot confirm more creative plans using the clause (iii) "indubitable equivalence" test. For example, a plan that replaces the secured creditor's original collateral with some other item of collateral (even if more valuable) could not be confirmed over the secured creditor's objection. *Compare, In re River East Plaza, LLC.*, 669 F.3d 826 (7th Cir. 2012) (attempting to use clause (iii) to replace secured creditor's collateral with treasury bills of equal value).

The Supreme Court's decision in *Radlax* enhances the secured creditor's position in the Chapter 11 plan process and limits one of the debtor's options for dealing with secured claims. The extra leverage secured creditors now have should change the negotiating dynamic in Chapter 11 cases, although debtors still retain leverage through the strategies noted above.

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