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Bankruptcy Report:

Seventh Circuit Rejects Rulings of Third and Fifth Circuits Denying a Secured Creditor's Right to Credit Bid at a Sale if Assets Free and Clear of Liens Under a Plan of Reorganization; U.S. Supreme Court May Resolve the Conflict

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Contested Chapter 11 proceedings often boil down to a two-party dispute between the debtor (and its owners) and the debtor's senior secured creditor, especially in single asset real estate and similar cases. In recent years, the playing field has not been a level one, with secured creditors having the upper hand in defeating any plan of reorganization the debtor (and its owners) might propose. Since the U.S. Supreme Court's decision in *Bank of America Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle Street Partnership*, 526 U.S. 434 (1999), it has been extremely difficult for a debtor to confirm a nonconsensual plan over the objection of its senior secured creditor. Following *In re 203 N. LaSalle*, courts have required debtors to either terminate plan exclusivity to allow other parties in interest -- including secured creditors -- to propose a competing plan, or put the new equity in the reorganized debtor up for auction, with secured creditors entitled to "credit bid" their claims. A credit bid generally cosists of a secured creditor bidding in some or all of its debt (rather than cash) at an auction of the assets of, or equity interests in, the debtor. By credit bidding their claims, secured creditors can often outbid any

cash buys and effectively block confirmation of the debtor's plan because their claims frequently exceed the fair market value of the debtor's assets.

In response to this situation, enterprising debtors have embarked on a strategy of selling their assets free and clear of liens under a plan -- often to a buyer with ties to the debtor or its pre-petition owners, and in the process denying secured creditors the right to credit bid. Secured creditors have typically objected to this type of plan, which required the debtor to seek confirmation under the cramdown provisions of section 1129(b)(2) of the Bankruptcy Code. To satisfy section 1129(b)(2), a debtor must demonstrate that the plan is "fair and equitable". With respect to secured creditors, the debtor is required to prove that its plan is fair and equitable under section 1129(b)(2)(A), which provides:

> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> (A) With respect to a class of secured claims, the plan 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;
>
> (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.

11 U.S.C. § 1129(b)(2)(A). Rather than proposing the sale of assets free and clear of liens under section 1129(b)(2)(A)(ii) of the Bankruptcy Code, which explicitly requires that a secured creditor be entitled to credit bid under section 363(k), debtors instead have proposed a sale without credit bidding rights under section 1129(b)(2)(A)(iii), arguing that the sale provides the "indubitable equivalent" of the secured creditor's claim.

In March 2010, in a divided opinion in *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010), the U.S. Court of Appeals for the Third Circuit gave debtors (and their owners) a major victory. The majority held that a chapter 11 debtor may satisfy the "fair and equitable" requirement of section 1129(b)(2)(A) by proposing a sale of assets free and clear of liens under a plan without granting secured creditors the right to credit bid. Although such a sale would violate section 1129(b)(2)(A)(ii), which expressly requires that secured creditors have the right to credit bid, the majority held that such a sale would nevertheless satisfy section 1129(b)(2)(A)(iii) if it provided secured creditors with the "indubitable equivalent" of their secured claims.

In reaching its decision, the majority relied on *In re Pacific Lumber, Co.*, 548 F.3d 229 (5th Cir. 2009), in which the U.S. Court of Appeals for the Fifth Circuit reached the same conclusion. Through a detailed analysis of section 1129(b)(2)(A) and canons of statutory construction, the *Philadelphia Newspapers* majority found that section 1129(b)(2)(A)(ii) is not the exclusive cramdown provision governing a sale of assets free and clear of liens under a plan, but that the "indubitable equivalent" standard of section 1129(b)(2)(A)(iii) may also sanction such a sale where, for example, the secured creditor is not granted the right to credit bid. The majority found that subsections (i), (ii), and (iii) of section 1129(b)(2)(A) of the

Bankruptcy Code are each equally available (and not even exhaustive) alternatives for a debtor to meet the "fair and equitable" requirement. The Third Circuit acknowledged, however, that an asset sale free and clear of liens under a plan that denies the right to credit bid will not prevail in every instance, but rather the debtor must still prove that such a sale provides the indubitable equivalent of the secured creditor's claim.

In a spirited dissent, Judge Ambro rejected the *Philadelphia Newspapers* majority's reasoning. He argued, on plain meaning, statutory construction and other grounds, that the indubitable equivalent standard is not an equally available alternative to subsections (i) and (ii) (as contended by the majority), but rather subsection (iii) is a mere "catch all" provision that does not displace the more specific provisions found in subsections (i) and (ii) with respect to the sales of assets under a plan. Judge Ambro ultimately found that any proposed sale of assets free and clear of liens under a plan must comply with the specific requirements of section 1129(b)(2)(A)(ii), including providing secured creditors the right to credit bid.

In June, 2011, the U.S. Court of Appeals for Seventh Circuit entered the fray in the *Matter of River Road Hotel Partners, LLC, et al.*, ___ F.3d ___, 2011 WL 2547615 (7th Cir. June 28, 2011), and handed secured creditors a big win. The Seventh Circuit rejected the majority decision in *Philadelphia Newspapers* (and the Fifth Circuit's decision in *Pacific Lumber*), and instead adopted Judge Ambro's dissent, holding that a plan proposing a sale of assets free and clear of liens must provide secured creditors with the right to credit bid in order to satisfy the "fair and equitable" requirement. In reaching its decision, the Seventh Circuit found that the language of section 1129(b)(2)(A) is ambiguous. *See River Road Hotel Partners*, 2011 WL 2547615 *6 ("Nothing in the text of Section 1129(b)(2)(A) directly indicates whether Subsection (iii) can be used to confirm any type of plan or if it can only be used to confirm plans that propose disposing of assets in ways that can be distinguished from those covered by Subsections (i) and (ii). Hence, there are two plausible interpretations of the statute: one that reads Subsection (iii) as having global applicability and one that reads it as having much more limited scope.") (citing *Philadelphia Newspapers*, 599 F.3d at 324-27) (Ambro, J., dissenting)) (internal footnote omitted).

Because section 1129(b)(2)(A) is ambiguous, the Seventh Circuit looked beyond the text of that section to determine which of its possible interpretations was the correct one. Among other things, the Seventh Circuit applied principles of statutory construction to determine that plans proposing a sale of assets free and clear of liens must afford secured creditors the right to credit bid. The Seventh Circuit found that a contrary interpretation would render superfluous the specific provision set forth in subsection (ii) requiring that secured creditors have the right to credit bid. The Seventh Circuit also found that such an interpretation would be at odds with how the interests of secured creditors are treated in other parts of the Bankruptcy Code that permit them to guard against undervaluation of their collateral, including section 363(k) (granting secured creditors the right to credit bid at non-plan sales), section 1111(b) (granting non-recourse secured creditors the right to elect to have their claims treated as fully secured), and section 1129(b)(2)(A)(ii) (granting secured creditors the right to credit bid at asset sales under a plan). The Seventh Circuit noted that in contrast, the Bankruptcy Code does not appear to contain any provisions that recognize an auction sale where credit bidding is unavailable as a legitimate way to dispose of encumbered assets.

The decisions in *Pacific Lumber* and *Philadelphia Newspapers* on the one hand, and *River Road Hotel Partners* and Judge Ambro's dissent in *Philadelphia Newspapers* on the other hand, provide equal fodder for debtors and secured creditors in contested plan proceedings in courts outside the Third, Fifth and Seventh Circuits, at least for now. On August 5, 2011, the debtor in *River Road Hotel Partners* filed a petition for *certiorari* to the U.S. Supreme Court. If the Supreme Court takes the case, it will resolve once and for all whether a debtor may properly deny a secured creditor the right to credit bid at a sale of assets free and clear of liens under a contested plan. Otherwise, the conflict between debtors (and their owners) and secured creditors on this issue will continue. ■

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