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Creditors Rights, Loan Enforcement *and* Creditor Bankruptcy Representation



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In the News:

## Supreme Court Affirms Rights of Secured Parties to Credit Bid in Bankruptcy Court

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On May 29, 2012, the Supreme Court resolved a split in authority between the Seventh Circuit<sup>1</sup> and the Third Circuit/Fifth Circuits<sup>2</sup>, providing that secured parties in bankruptcy retain the right to credit bid the amount of their debt in proposed Chapter 11 plans where the debtor is seeking to sell the secured party's collateral to a third-party buyer free and clear of the secured party's liens. This decision is important to lenders, as it preserves for the secured lender the discretion,

for which it bargained when it made its loan to the debtor, to determine whether a specific amount to be paid for its collateral is less than what the secured lender believes the collateral is worth.

### What is Credit Bidding?

A credit bid is a bid by a secured party at a sale (typically a foreclosure, trustee's, or UCC sale) whereby the secured party's bid consists of a "credit" against the

<sup>1</sup> *In re River Road Hotel Partners, LLC*, 651 F.3d 642 (7<sup>th</sup> Cir. 2011).

<sup>2</sup> *In re Philadelphia Newspapers*, 599 F.3d 298 (3<sup>rd</sup> Cir. 2010); *In re Pacific Lumber Co.*, 584 F.3d 229 (5<sup>th</sup> Cir. 2009).

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amount already owed to the secured party by its borrower. This payment by "credit bid" is made in lieu of the secured party bidding cash at the sale, which is the typical requirement imposed on other, third-party bidders. (For example, if a secured party is owed \$1,000,000 from a borrower secured by a lien on property securing that debt, at the foreclosure sale of that property, the secured party may bid up to \$1,000,000 without having to "go into pocket" to bid at the sale).

## Rationale

Removal of the credit bid protection would enable a debtor to sell to a third party a property for less than the debt the debtor owes to its secured lender, but without affording the lender the option to acquire the property itself by credit bidding an amount greater than what is being paid by the proposed third-party purchaser. By allowing secured parties to credit bid, "the Code promises lenders that their liens will not be extinguished for less than face value [of their debt] without their consent."<sup>3</sup> Credit bidding also "enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to the loan."<sup>4</sup>

## How Does Credit Bidding Work In Bankruptcy?

Assets are sold in one of two ways in bankruptcy court: (1) by the debtor or trustee through a motion, often referred to as a "363 sale" (because the

Bankruptcy Code section that allows this is 11 U.S.C. § 363); or (2) by way of a plan of reorganization under chapter 11. Credit bidding is specifically allowed under 363 sales under 11 U.S.C. § 363(k), unless the bankruptcy court finds "cause"<sup>5</sup> that such credit bidding shall not be allowed. Bankruptcy courts have also held that secured creditors have a right to credit bid, no matter what the asserted value of the collateral being sold is.<sup>6</sup>

Although expressly allowed under 363 sales, there was uncertainty regarding whether such credit bidding rights extended to sales called for in plans of reorganization. This uncertainty developed from section 1129(b) of the Bankruptcy Code, which provides alternatives for approving a plan over the objections of a secured creditor—the two relevant provisions allowing the debtor to either propose a 363 sale or to provide the lender with the "indubitable equivalent" of the lender's secured claim. Debtors had advanced arguments that as long as creditors were being provided with the "indubitable equivalent" of their secured claims, the secured creditors' right to credit bid did not need to be preserved because the "indubitable equivalent" option was set forth in the Code as an alternative to the right to credit bid.

<sup>3</sup> *In re River Road Hotel Partners, LLC*, 651 F.3d 642 (7<sup>th</sup> Cir. 2011).

<sup>4</sup> *Radlax Gateway Hotel LLC v. Amalgamated Bank*, (*In re River Road Hotel Partners, LLC*), 2012 WL 1912197 (2012).

<sup>5</sup> Courts have held that "cause" can include when a mortgage lender's lien is subject to avoidance as a preference. See *In re Daufuskie Island Properties, LLC*. 2010 WL 4781068 (Bankr. D.S.C. 2010).

<sup>6</sup> *In re Submicron Systems Corporation*, 432 F.3d. 448 (3<sup>rd</sup> Cir. 2004); *In re Lake Country Investments*, 255 B.R. 588 (Bankr. D. Idaho 2000).



## Credit Bidding in Plan – Circuits Split

In a lengthy opinion, the Third Circuit<sup>7</sup> agreed with the Fifth Circuit<sup>8</sup> that debtors proposing to sell assets free and clear of liens in plans of reorganization do not necessarily need to provide secured creditors with the right to credit bid. The Third and Fifth Circuits reasoned that as long as the secured creditor was being provided with the “indubitable equivalent” of its secured claim, the right to credit bid was not necessary to a confirmable plan. The rationale was that if the Debtor could show that the property was being sold at a fair market value and that the net sale proceeds were being delivered to the lender, the lender was receiving the “indubitable equivalent” of its secured claim. Secured lenders, of course, have disagreed, reasoning that, with respect to their collateral, they too are part of the “buyers’ market,” and, in any case where they would opt to credit bid more than the proposed sale price in the plan, they would not *ipso facto* be receiving the indubitable equivalent of their secured claim, since there is a purchaser (the lender itself) willing to pay more to acquire the property.

Judge Ambro of the Third Circuit wrote a 49-page dissent criticizing the majority opinion. In a later case, the Seventh Circuit largely followed the reasoning in Judge Ambro’s dissent and ruled that the lender could not be deprived the right to credit bid at a sale under a plan. The Seventh Circuit decision set the stage for resolution of the issue by the United States Supreme Court.

## Supreme Court Decision

The debtor in the Seventh Circuit case appealed to the Supreme Court. In a relatively short opinion, *Radlax Gateway Hotel LLC v. Amalgamated Bank, (In re River Road Hotel Partners, LLC)*<sup>9</sup> the Supreme Court affirmed the opinion of the Seventh Circuit.

In *Radlax*, the lender provided the debtor with a \$142 million dollar loan to purchase a hotel and additional ground near Los Angeles International Airport and also to renovate the hotel and construct a parking facility. After incurring a number of cost overruns, the debtor filed for bankruptcy. The amount owed to the lender was approximately \$120 million. The debtor proposed a sale of the property under the debtor’s chapter 11 plan to a proposed third-party buyer for \$55 million, with no right for the lender to credit bid. The lender objected. The bankruptcy ruled that the plan was not confirmable because the lender was not allowed to credit bid at the sale under the plan. Appeal was taken directly to the Seventh Circuit, which affirmed the bankruptcy court.

On appeal, the Supreme Court said that the debtor’s arguments, which would allow a more general clause to defeat what a specific clause forbade, was “hyperliteral and contrary to common sense.” Through various means of interpreting the statute, the Court decided that the general indubitable equivalent language could not supplant the specific requirements for credit bidding.

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<sup>7</sup> *In re Philadelphia Newspapers*, 599 F.3d 298 (3<sup>rd</sup> Cir. 2010).

<sup>8</sup> The Court noted the methods span from a flat prohibition on deficiency judgments in certain contexts to the approaches discussed here. *Id.* at \*8.

<sup>9</sup> 2012 WL 1912197 (2012).



The decision stands for the proposition that a secured party has the right to credit bid when a debtor seeks to sell the lender's collateral free and clear of liens under a plan of reorganization. The case may not, however, end the quest of innovative debtors to eliminate lenders' credit bid rights, and future debtors may opt

instead to try to rely on the language in Section 363(k) of the Code that preserves the lender's credit bid right – citing a caveat in such provision stating that the lender has the right to credit bid “unless the court for cause orders otherwise.” ■



### For More Information

For more information, or if you have any questions regarding creditors rights, loan enforcement or creditor bankruptcy representation, please contact:

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## About

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