

Finance and Restructuring Update Seventh Circuit Hands Secured Lenders a Major Victory - Splits the Circuits by Holding that Secured Creditors Have Right to Credit Bid Under Plan Sales

Finance and Restructuring Update

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By George R. Mesires

On June 28, 2011, the United States Court of Appeals for the Seventh Circuit affirmed the Bankruptcy Court for the Northern District of Illinois' decision and held that a secured creditor has a statutory right to credit bid its debt in the sale of assets proposed under a non-consensual plan of reorganization pursuant to Section 1129(b)(2)(A) of the Bankruptcy Code. See *River Road Hotel Partners, LLC v. Amalgamated Bank*, Case No. 10-3597, ___ F.3d ___ (7th Cir. June 28, 2011). The case is significant for at least two reasons. First, the Seventh Circuit is the first judicial circuit to recognize that a secured creditor has the absolute right to credit bid at an auction sale held pursuant to a plan of reorganization if such sale seeks to sell the assets free and clear of liens. Second, the Seventh Circuit decision splits from its sister circuits (the Third and Fifth Circuits) and potentially makes the unsettled question of law ripe for consideration by the United States Supreme Court.

In its decision, the Seventh Circuit splits from the Third Circuit's decision in 2010 in *Philadelphia Newspapers* and the Fifth Circuit's decision in 2009 in *Pacific Lumber*, which held that, as a matter of law, a debtor may preclude a secured creditor from credit bidding when a debtor sells its assets pursuant to a plan of reorganization and provides the creditor with the indubitable equivalent of its claims. See *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3rd Cir. 2010); see also *In re The Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009). Citing favorably to Judge Thomas L. Ambro's dissent in the *Philadelphia Newspapers* case, but conducting its "own independent analysis of 1129(b)(2)(A)'s meaning," the Seventh Circuit held that the plain language of Section 1129(b)(2)(A) does not authorize the confirmation of a plan of reorganization that denies a secured creditor the right to credit bid in connection with a plan sale. See *River Road Hotel Partners*, ___ F.3d ___.

Background - Sales of Assets Outside the Ordinary Course in Bankruptcy

In bankruptcy, a debtor may sell its assets outside of the ordinary course of business in two ways: (i) under section 363 of the United States Bankruptcy Code the ("Bankruptcy Code"); or (ii) pursuant to a plan of reorganization under section 1123 of the Bankruptcy Code.

Under Section 363, unless the court for cause otherwise orders, a secured creditor may credit bid its claim. Credit bidding is the ability of a secured lender to offset its claim against the purchase price of the property. See 11 U.S.C. §353(k); 3 *Collier on Bankruptcy* ¶363.09 (Alan N. Resnick & Henry J. Sommers eds., 16th ed. 2010). For a secured lender, credit bidding helps to ensure that the collateral is not sold for less than the face amount of the debt, and can preserve the ability of the secured creditor to participate in any appreciation of the value of its collateral. In other words, the secured creditor uses some or all of the amount of its claim as a source of payment at an auction such that if the secured creditor is the winning bid, no exchange of money need occur and the amount of the bid is offset against the amount of the outstanding debt. Credit bidding protects the secured lender against attempts to sell the collateral too cheaply if the secured creditor thinks the collateral is worth more than the sale price.

Alternatively, a debtor can sell its assets pursuant to a plan of reorganization. A plan of reorganization can be approved over the objection of creditors, including a secured

creditor, under the “cramdown” provisions of the Bankruptcy Code.¹ To cramdown a secured creditor, among other things, the reorganization plan must be “fair and equitable” to the secured creditor. The “fair and equitable” standard may be satisfied by showing that the plan provides: (1) that the holders of such claims retain the liens securing such claims and receive deferred cash payments having a present value equal to the value of their collateral; (2) for the sale of the collateral free and clear of liens (with such lien attaching to the sale proceeds of the sale) but subject to the secured creditor’s right to credit bid (the “Sale Prong”); or (3) for the realization of the secured creditor’s claim by some means which provides the secured creditor with the “indubitable equivalent” of its claim (the “Indubitable Equivalent Prong”).

The River Road Hotel Partners Case

In the *River Road Hotel Partners* case, the debtors proposed selling substantially all of their assets, consisting mainly of the InterContinental Hotel Chicago O’Hare, pursuant to a plan of reorganization. As part of its plan, the debtors sought to deny the lenders the ability to credit bid their debt as a matter of law under the Indubitable Equivalent Prong, and for cause under Section 363(k).

In its bid procedures motion, the debtors cited the plain language of 1129(b)(2)(A)(iii) and *Philadelphia Newspapers* to seek to deny the lenders the ability to credit bid as a matter of law. Even if the court denied the debtors’ request to preclude the lenders from credit bidding under section 1129, the debtors argued that the lenders should be precluded from credit bidding for cause. The debtors cited the following factors, among others, as establishing cause under Section 363(k): (i) there exist disputes regarding the priority of competing secured creditors; (ii) granting an unsecured creditor the right to credit bid would chill the bidding process; and (iii) the lenders “precipitated” the debtors’ chapter 11 cases by “improperly refusing to provide funding” under the loan agreements.

On October 5, 2010, Judge Bruce W. Black of the bankruptcy court denied the debtors’ bid procedures motion citing Judge Ambro’s “well-reasoned dissent” in *Philadelphia Newspapers*. In that dissent, Judge Ambro noted that “it seems Pickwickian to believe that Congress would expend the ink and energy detailing procedures in clause (ii) that specifically deal with plan sales of property free of liens, only to leave general language in clause (iii) that could sidestep entirely those procedures.” *Philadelphia Newspapers* at 329. Judge Ambro also reasoned that denying the lenders the ability to credit bid would only benefit stalking horse acquirors by allowing such acquirors to potentially acquire assets below market value. Further, the court found that the debtors failed to demonstrate “cause” sufficient to justify barring the lenders to credit bid at auction.

After certification of appeal to the court of appeals in October 2010, the Seventh Circuit’s ruling on June 28, 2011 held that “the plain language of 1129(b)(2)(A) does not clearly authorize confirmation of the Debtors’ reorganization plans” because the statute does not have a single plain meaning – “there are two plausible interpretations of the statute: one that reads Subsection (iii) [the Indubitable Equivalent Prong] as having global applicability and one that reads it as having a much more limited scope.” *River Road Hotel Partners, LLC v. Amalgamated Bank*, 10-3597, ___ F.3d ___ (7th

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¹ In the *River Road Hotel Partners* decision, the Seventh Circuit explained the derivation of the term “cramdown”: “Plans that are confirmed under Section 1129(b) are often referred to as cramdown plans because they have been “crammed down the throats of objecting creditors.” *River Road Hotel Partners, LLC v. Amalgamated Bank*, 10-3597, ___ F.3d ___ (7th Cir. June 28, 2011), citing *Kham & Nate’s Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1359 (7th Cir. 1990).

Cir. June 28, 2011) (citing *Philadelphia Newspapers*, 599 F.3d at 324-27 (Ambro, J., dissenting)). Looking beyond the text of Section 1129(b)(2)(A) – as it must if the statute does not have single plain meaning – the Seventh Circuit was influenced by the way auctions are recognized and the way secured creditors are treated elsewhere in the Bankruptcy Code. In both Section 363(k) and 1129(a)(2)(B)(ii) a secured creditor is permitted to credit bid, which “promises lenders that their liens will not be extinguished for less than face value without their consent ... Because the Debtors’ proposed auction would deny secured lenders the ability to credit bid, they lack a crucial check against undervaluation. Consequently, there is an increased risk that the winning bids in these auctions would not provide the Lenders with the current market value of the encumbered assets [i.e., indubitable equivalent value].” *River Road Hotel Partners*, ___ F.3d ___.

The Seventh Circuit found also that canons of statutory construction weighed against the debtors’ proposed interpretation of 1129(b)(2)(A). Specifically, the debtors’ interpretation would render the first two Subsections of 1129(b)(2)(A) superfluous: if “Subsection (iii) permits a debtor to sell an asset free and clear of liens without permitting credit bidding, then it is difficult to see what, if any, significance Subsection (ii) can have. Similarly, the Debtors’ interpretation would permit properly-designed reorganization plans to sell encumbered assets without satisfying the conditions set forth in Subsection (i). We cannot conceive of a reason why Congress would state that a plan must meet certain requirements if it provides for the sale of assets in particular ways and then immediately abandon these requirements in a subsequent subsection.” *River Road Hotel Partners, LLC v. Amalgamated Bank*, 10-3597, ___ F.3d ___ (7th Cir. June 28, 2011).

Since 2009, debtors have sought to leverage the *Pacific Lumber* and *Philadelphia Newspapers* decisions and seek to deny secured creditors the right to credit bid under plan sales. The Seventh Circuit’s ruling should be deflating to emboldened debtors, at least in the Seventh Circuit, and provide some assurance that secured creditors in the Seventh Circuit may exercise their right to credit bid under both Section 363 of the Bankruptcy Code *and* an auction sale proposed under a plan of reorganization. However, because this judicial decision does split the judicial circuits, there may now be disparate results, making this issue ripe for resolution by the Supreme Court.

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