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Supreme Court Closes Loophole around Secured Creditor's Right to Credit Bid

The United States Supreme Court issued its decision in the *RadLAX Gateway Hotel v. Amalgamated Bank* case on May 29, 2012, closing the door on a debtor's end-around a secured creditor's right to credit bid.[1] In a unanimous decision delivered by Justice Scalia, the Supreme Court found its answer to be "an easy case," rejecting recent decisions allowing a debtor to sell secured property free and clear of all liens without providing for the secured party's credit bid rights when the sale was pursuant to a plan of reorganization.[2] The decision provides secured creditors with predictability and consistency whether its collateral is being sold pursuant to a proposed plan or a sale during the bankruptcy case.

Case Background

Debtors RadLAX Gateway Hotel, LLC, and RadLAX Gateway Deck, LLC, borrowed in excess of $140 million to finance the purchase and renovation of the Radisson Hotel at the Los Angeles International Airport and to build a parking structure. In return, their lenders obtained a blanket lien on all of their assets to secure repayment of the loan. At the time of their bankruptcy filings in August 2009, construction had not been completed and more than $120 million remained due on the loan. In connection with their proposed plans of reorganization, the debtors sought to auction substantially all of their assets, including the collateral of their pre-petition lenders, with an initial bid submitted by a "stalking horse" of $47.5 million. In the debtors' Sale and Bid Procedures Motion filed contemporaneously with their plans, the sale would be free and clear of the lenders' liens and would preclude the lenders from submitting a credit bid at the auction.[3]

The bankruptcy court rejected the debtors' procedures, stating that a debtor cannot sell encumbered assets free and clear of liens under a plan unless it allows the secured party to credit bid under Section 1129(b)(2)(A)(ii). On a direct appeal, the Seventh Circuit upheld the bankruptcy court's denial of the debtors' proposed sale precluding credit bids.[4]

Sales Free and Clear of Liens

There are basically two processes for a debtor to sell its assets: (1) during the bankruptcy case upon motion pursuant to Section 363 of the Bankruptcy Code and (2) in the implementation of the debtor's plan of reorganization pursuant to Section 1123(a)(5)(D). All sales conducted pursuant to Section 363 specifically provide for a secured creditor's right to credit bid under subsection (k) of Section 363. The right to credit bid allows the creditor to offset its bid with the debt owed instead of cash or other consideration.[5] The purpose of Section 363(k) is to provide a check upon the debtor's proposed sale price by permitting the secured creditor to take the collateral if the proposed sale price would not pay the secured creditor in full and the creditor believes it could do better.[6]

Section 1123(a)(5)(D), however, does not provide the same guidance on the procedures for sales pursuant to a plan of reorganization. Instead, the parties must look to Section 1129(b)(2)(A), which provides the alternatives under which a debtor can force a particular treatment under a plan of reorganization upon a secured creditor over its objection, typically referred to as a "cram-down" provision. Section 1129(b)(2)(A) provides the following three alternatives:

(i) the secured creditor's liens remain on its collateral and its claim is paid over time,

(ii) the secured collateral is sold free and clear of all liens subject to the secured creditor's credit bid rights under Section 363(k), or

(iii) the secured creditor is provided the "indubitable equivalent" of its claim.[7]

Fifth and Seventh Circuit – Plain Meaning

Until 2009, it was generally accepted that all sales, including those pursuant to a plan, required the allowance of credit bids. The Fifth Circuit, however, began to chip away at this view with its decision in *Scotia Pacific Co. v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*.[8] In *Pacific Lumber*, the Fifth Circuit focused on the plain reading of the statute with the disjunctive "or" separating the three distinct alternatives for confirming a plan over the secured party's objection. The court determined it did not need to go beyond the "plain meaning" of the statute, and therefore it did not need to consider the underlying purpose of Section 363(k) and the protections it provides over the value of the collateral. In other words, as long as the debtor satisfied one of the three alternatives, the plan could be approved.

In 2010, the Third Circuit applied that analysis in its decision in *In re Philadelphia Newspapers, LLC*.[9] In *Philadelphia Newspapers*, under similar facts found in the *RadLAX* case, the Third Circuit approved the debtors denial of their secured lender's right to credit bid because the proposed auction was pursuant to a plan of reorganization. As in *Pacific Lumber*, the Third Circuit found that separating the three alternatives with the word "or" creates three independent alternatives for approval of a plan and therefore approved the debtors' proposal subject to the debtors' satisfying the third alternative of Section 1129(b)(2)(A).

Seventh Circuit Goes Beyond Plain Meaning

The Seventh Circuit rejected the conclusions in *Philadelphia Newspapers* and *Pacific Lumber* that the mere presence of the term "or" was sufficient to resolve the analysis of the Section 1129(b)(2)(A) alternatives.[10] Instead, the Seventh Circuit found that subsection (iii) is ambiguous because it does not indicate that it applies to plans that propose to sell encumbered assets free and clear of liens. Further, that accepting the debtors' interpretation of subsection (iii) would render subsection (ii) superfluous as it would allow a debtor to sell encumbered assets free and clear of all liens without the credit bid rights required under subsection (ii). As the Seventh Circuit noted, courts are to construe ambiguous text to give meaning to the entire statute and, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.[11] Lastly, the Seventh Circuit found that allowing such sales under subsection (iii) would contravene the purpose of a secured creditor's credit bid rights under section 363(k), as discussed above, to provide a check on the sale price of the collateral and protect against the risk of undervaluation.[12]

Supreme Court Affirms Credit Bid Rights in Sales Under Plan

The Supreme Court has now resolved the split of authority, siding unanimously with the Seventh Circuit. The decision's main focus is on statutory interpretation and the norm that specific governs the general.[13] The Supreme Court rejected the debtors' reading of Section 1129(b)(2)(A), in that clause (iii) permits precisely what clause (ii) proscribes but without the Section 363(k) credit bid rights. The Court notes that where a statute provides a general authorization next to a specific authorization, the general rule is to avoid the specific provision from being swallowed by the general one, giving effect to every clause and part of the statute.[14]

The Supreme Court therefore held that in order for a debtor to sell its assets free and clear of liens pursuant to its plan of reorganization, it must provide the secured creditor with the right to credit bid under clause (ii), the specific authorization. Further, that clause (iii) does not include such sales. The Court, however, did not delve into the meaning of clause (iii)'s "indubitable equivalent," but instead gave the example of a plan that gives the secured creditor its collateral in satisfaction of its secured claim.[15]

This decision was not a surprise given the obvious skepticism of the debtors' positions during the April 23, 2012, oral arguments. This continued to the decision in the Court's description of the debtors' reading of Section 1129(b)(2)(A) as "hyperliteral and contrary to common sense."[16]

Purpose of Credit Bid Rights Affirmed

Underlying the Supreme Court's decision was an acknowledgement of the purpose of the Section 363(k) credit bid rights. As the Court stated, "[t]he ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price." The secured creditor is therefore afforded the opportunity to purchase the collateral at a price it considers the fair market value (up to the amount of its allowed secured claim) without committing additional funds.[17] A particularly important right for the federal government, which often lacks the authority to spend additional funds in a cash-only bankruptcy auction.[18]

Conclusion

The final result is that the status quo that existed before *Philadelphia Newspapers* and *Pacific Lumber* is without question. All sales by a debtor, both pursuant to plans of reorganization as well as during the bankruptcy case pursuant to a Section 363 motion, must provide for a secured creditor's credit bid rights under Section 363(k).

Secured creditors should still get a determination early in the bankruptcy case of the amount of their claim, such as in a cash collateral or debtor-in-possession financing order, including a reaffirmation from the debtor of such debt. While the Bankruptcy Code includes other potential limitations not discussed herein, an early determination will provide the secured creditor a good basis for its credit bid amount in any potential sale of its collateral by the debtor.

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1. *RadLAX Gateway Hotel v. Amalgamated Bank*, No. 11-166 (U.S. May 29, 2012) ("*RadLAX*").
2. Justice Kennedy took no part in the decision.
3. *RadLAX*, slip op. at 1-3.
4. *Id.*
5. 11 U.S.C. § 363(k) provides:
   At a sale under subsection (b) of [Section 363] of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.
6. See *In re Requilman*, 2009 LEXIS 4098, 15 (Bankr. N.D. Cal., December 14, 2009) (citing *In re Woodridge North Apts., Ltd.*, 71 B.R. 189, 191-92 (Bankr. N.D. Cal. 1987).
7. 11 U.S.C. 1129(b)(2)(A)(i)-(iii).
8. 584 F.3d 229 (5th Cir. 2009).
9. 599 F.3d 298 (3rd Cir. 2010).
10. *River Road Hotel Partners, LLC v. Amalgamated Bank* (*In re River Road Hotel Partners, LLC*), 651 F.3d 642 (7th Cir. 2011) ("*River Road*").
11. *River Road*, 651 F.3d at 652 (citing *Duncan v. Walker*, 533 U.S. 167, 174 (2001)).
12. *River Road*, 651 F.3d at 643-45.
13. *RadLAX*, slip op. at 5 (citing *Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 384 (1992)).
14. *RadLAX*, slip op. at 6 (citing *D. Ginsberg & Sons, Inc. v. Popkin*, 285 U.S. 204, 208 (1932)).
15. *RadLAX*, slip op. at 7-8.
16. *RadLAX*, slip op. at 5.
17. *RadLAX*, slip op. at 4, fn 2.
18. The Federal Government filed an amicus brief arguing, in part, that it has loan guarantee portfolios in the billions of dollars and it faces particular limitations in bidding cash, such as the Anti-Deficiency Act - 31 U.S.C. 1341, that would put it at a disadvantage if its credit bid rights were lost. *RadLAX*, Brief for the United States as Amicus Curiae Supporting Respondent at 28-30.

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