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# Supreme Court Upholds Credit Bidding Rights in Bankruptcy Sales in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*

On May 29, 2012, the United States Supreme Court issued its decision in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. ___ (2012), which affirmed that secured creditors have the right to use their claims to credit bid in auctions of their collateral conducted under bankruptcy reorganization plans. The decision is a victory for secured lenders because these credit bid rights ensure that, in the context of a collateral sale, secured lenders will be able to use their claims to purchase their collateral if they are not being repaid in full.

## I. Case Background

Under the laws of most states, a secured creditor has the right to "credit bid" at a foreclosure auction by using the amount of its claim secured by the collateral being auctioned to bid in lieu of cash. Credit bidding thus reduces a lender's need for liquidity during an auction process, while leaving a lender with discretion to "accept" a bid that is lower than the amount owed to the lender.

In bankruptcy, a debtor's property is often liquidated through auction processes instead of under non-bankruptcy foreclosure laws. These auctions are typically accomplished either through stand-alone sale procedures or as part of a plan of reorganization under Chapter 11 of the U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq*.

For stand-alone sales, § 363(k) of the Bankruptcy Code specifically preserves credit bid rights for secured lenders unless there is "cause" for the bankruptcy court to order otherwise. 11 U.S.C. § 363(k).

However, different provisions of the Bankruptcy Code apply to Chapter 11 plans. A plan providing for the sale of property free and clear of liens can be confirmed if either (a) the liens attach to the proceeds of the sale and the sale is conducted subject to the lienholders' § 363(k) credit bid rights, *see* 11 U.S.C. § 1129(b)(2)(A)(ii), or (b) the bankruptcy court finds that the lienholders will realize under the plan the "indubitable equivalent" of their "secured claims." 11 U.S.C. § 1129(b)(2)(A)(iii).

It had been unclear whether a no-credit-bid sale of encumbered assets, which is forbidden under Subsection (ii) of § 1129(b)(2)(A), could nevertheless be approved under the broader "indubitable equivalent" standard of Subsection (iii). The Supreme Court answered this question in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. ___ (2012) with a firm "no."

## II. Conflicting Lower Court Opinions

Three recent opinions from various United States Courts of Appeals arrived at different conclusions regarding credit bid rights in sales under Chapter 11 plans. In *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010), the Third Circuit reviewed an order approving sale procedures in connection with a proposed Chapter 11 plan that would not preserve the secured lender's credit bid rights. The Third

Circuit held that these sale procedures were permissible because a "plain reading" of § 1129(b)(2)(A)(iii) "permits the [d]ebtors to proceed … without allowing the [l]enders to credit bid." *Id*. at 318.

Importantly, the Third Circuit in *Philadelphia Newspapers* noted that the lender would still need to be provided with the "indubitable equivalent" of the value of its secured claim, and that the debtor had not yet proven this "critical" fact:

> The auction of the Debtors' assets has not yet occurred. Other public bidders may choose to submit a cash bid for the assets. The value of the real property that the Lenders will receive, in addition to cash, under the terms of the proposed plan has not yet been established. And the secured claim itself has not yet been judicially valued under § 506(a). We are simply not in a position at this stage to conclude, as a matter of law, that this auction cannot generate the indubitable equivalent of the Lenders' secured interest in the Debtors' assets.

*Id*. at 313. In other words, *Philadelphia Newspapers* did not necessarily produce poor results for the lender — the ultimate issue of the value the lender would recover was not resolved by this appeal.

Like the Third Circuit in *Philadelphia Newspapers*, the Fifth Circuit in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009), had emphasized that, even if a lender did not retain its credit bid rights, its interests were still adequately protected by the "indubitable equivalent" standard. "[W]hat is really at stake in secured credit," the court explained, is "repayment of principal and the time value of money." *Id*. at 246.

> Indubitable equivalent is therefore no less demanding a standard than its companions. The [no-credit-bid] plan obviated both of the [other § 1129(b)(2)(A)] bases for protection by offering cash allegedly equal to the value of the [collateral]. No need arose to afford collateral or compensate for delay in repayment. Whatever uncertainties exist about indubitable equivalent, paying off secured creditors in cash can hardly be improper if the plan accurately reflected the value of the [secured creditor's] collateral.

*Id*.

*Philadelphia Newspapers* and *Pacific Lumber* did raise the troubling potential that an undersecured creditor could, without the creditor's consent, and without the creditor being paid in full, both lose its lien on the collateral being sold *and* receive less than the full amount of the price paid for that collateral as a result of judicial valuation combined with a no-credit-bid sale under Subsection (iii) of § 1129(b)(a) of the Bankruptcy Code. This would work as follows: under § 506(a)(1) of the Bankruptcy Code, a lender only has a "secured" claim to the "extent of the value of such creditor's interest in the [bankruptcy] estate's interest in such property." The bankruptcy court can determine the value of this property interest, thereby determining the amount of the creditor's secured claim. In theory, a bankruptcy judge could value a secured creditor's claim at an amount lower than the prevailing bid for the collateral by somehow finding that the prevailing bid was in fact greater than the "value" of the collateral. Credit bidding rights protect a lender against this potential injustice by allowing the lender to bid the entire amount of its claim, thereby setting a minimum floor price for an auction. The dissent in *Philadelphia Newspapers* noted this concern:

> [W]hile many of the valuation mechanisms (such as judicial valuation or market auction) may theoretically result in a perfect valuation, Congress has provided the credit bid mechanism as insurance for secured creditors to protect against an undervaluation of assets sold. Secured creditors who believe their collateral is being sold for too low a price may bid it higher and use as credit the dollars they have already extended (together with interest and other secured costs) to debtors.

*Id*. at 332-33 (Ambro, J. dissenting).

Agreeing that "the right to credit bid" is an "important protection" against "the risk that the winning auction bid will not capture the asset's actual value," the Seventh Circuit in *River Road Hotel Partners, LLC v. Amalgamated Bank*, 651 F.3d 642 (7th Cir. 2011), rejected *Philadelphia Newspapers* and *Pacific Lumber*. The court first noted that credit bid rights are explicitly preserved in § 1129(b)(2)(A)(ii), which permits a plan to provide for "the sale, subject to § 363(k) [requiring credit bidding], 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[.]" *Id*. at 651. The Seventh Circuit refused to construe Subsection (iii)'s broad "indubitable equivalent" requirement to entirely subsume Subsection (ii)'s specific credit bid requirement, explaining that "[t]his understanding of [Subsection] (iii) is unacceptable because it would render the other subsections of the statute superfluous." *Id*. at 652.

The Seventh Circuit also implied that an auction without credit bidding rights could never satisfy the "indubitable equivalent" standard of Subsection (iii):

> Because the Debtors' proposed auctions 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.

*Id*. at 650. Unlike the Third Circuit in *Philadelphia Newspapers*, the Seventh Circuit in *River Road* did not favor a "wait-and-see" approach to the ultimate issue of whether the lender would be provided with the "indubitable equivalent" of its secured claim.

**III. Supreme Court Decision and Potential Impact upon Lenders**

The Seventh Circuit's *River Road* opinion was appealed to the Supreme Court under the style of *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*. The Court accepted the appeal, heard oral arguments on April 23, 2012, and issued an opinion affirming the Seventh Circuit on May 29, 2012. Justice Antonin Scalia delivered the opinion, which was joined by all justices except Justice Anthony Kennedy, who took no part in the decision.

The opinion is relatively short and focuses almost exclusively on textual statutory interpretation. In parsing the subsections of § 1129(b)(2)(A) of the Bankruptcy Code, the Supreme Court applied the statutory construction principal that "the specific governs the general," meaning that, to avoid "superfluity," the "specific provision is construed as an exception to the general one." Subsection (iii) is thus a "residual provision" that applies to plans *other than* plans under Subsections (i) or (ii).

The Supreme Court declined to include any policy analysis in *RadLAX*, stating "the pros and cons of credit bidding are for the consideration of Congress, not the courts." The Supreme Court instead emphasized its duty to "interpret the Code clearly and predictably using well established principles of statutory construction," and implied that this need for heightened adherence to proper construction was needed because the "Bankruptcy Code standardizes an expansive (and sometimes unruly) area of law."

*RadLAX* resolves a split in the circuits that could have been problematic. While "no-credit-bid sales" remain relatively uncommon and the "indubitable equivalent" standard ostensibly still provided substantial protections to lenders even if their credit bid rights were impaired, secured lenders can take comfort in the Supreme Court's reaffirmation of their credit bid rights.

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