Business Reorganization Committee

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Seventh Circuit Restores Balance between Debtor and Secured Creditor Interests in Circuit-Splitting *River Road Hotel* Decision

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Lenders no doubt received some measure of relief this summer when the Seventh Circuit in *River Road Hotel Partners LLC v. Amalgamated Bank*, 2011 U.S. App. LEXIS 13131 (7th Cir. June 28, 2011), embraced its own interpretation of "fair and equitable" treatment of dissenting secured creditors under a cramdown plan. Only recently did the Fifth Circuit (in its 2009 decision in *In re The Pacific Lumber Co.*) and, more notably, the Third Circuit (in its 2010 decision in *In re Philadelphia Newspapers, LLC*) hold that a secured creditor did not have the presumptive right to credit bid when a debtor proposed to sell encumbered property free and clear of liens under a chapter 11 plan. In *River Road*, [1]the Seventh Circuit held otherwise, concluding that a plan providing for the sale of property free and clear of liens without affording the lender the right to credit bid is not "fair and equitable" under § 1129(b)(2)(A) of the Bankruptcy Code. With the Seventh Circuit's circuit-splitting decision, the stage now appears set for final review by the Supreme Court.[2]

The Statute

Generally, in order for the court to confirm a chapter 11 plan, the plan must be accepted by each class of claims or must not impair any nonaccepting class of claims.[3] Notwithstanding this general requirement, the Bankruptcy Code authorizes the court to confirm a plan over the objection of an impaired class (*i.e.*, "cram down" a dissenting class) provided that the plan does not discriminate unfairly and is "fair and equitable" with respect to the dissenting class.[4] As set forth in § 1129(b)(2), "the condition that a plan be fair and equitable ... includes the following requirements:

> (A) With respect to a class of secured claims, the plan provides—
>
> (i) (I) that 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.

Section 363(k) of the Bankruptcy Code, referred to in subsection (ii) of § 1129(b)(2)(A), recognizes a right of secured creditors to protect against undervaluation of its collateral in bankruptcy sales by permitting a secured creditor to credit-bid the full amount of its debt at a sale of its collateral unless the court "for cause" orders otherwise.[5] However, § 363(k) technically applies only to sales pursuant to § 363(b). Section 1123 of the Bankruptcy Code, which authorizes a plan to provide for the sale of property "either subject to or free of any lien," makes no mention of either § 363(k) or credit-bidding. It is therefore only by the reference to § 363(k) in § 1129(b)(2)(A)(ii) that credit-bidding is implicated in a free-and-clear sale under a cramdown plan. But is the secured creditor's presumptive credit-bid right implicated in *all* free-and-clear sale plans, or is a plan proponent instead invited to proceed under the statute's neighboring subsection (iii), requiring the "realization of the indubitable equivalent," to confirm such sale plans?

The Cases

Prior to *Pacific Lumber* and *Philadelphia Newspapers*, it was generally thought that § 1129(b)(2)(A)(ii) was specifically intended to govern free-and-clear sales pursuant to a plan.[6] Moreover, few courts had attempted to divine the meaning of "indubitable equivalent" in the plan context. *Pacific Lumber* and *Philadelphia Newspapers*, the first circuit-level decisions to address the issue, changed the bankruptcy landscape for debtors and their secured lenders.

***Pacific Lumber* Decision**

Pacific Lumber[7] involved a chapter 11 reorganization in which competing plans were proposed by the indenture trustee for secured noteholders of one of the debtors and by the secured lender of another of the debtors (Marathon) after the debtors' exclusivity had been terminated. The bankruptcy court held that the indenture trustee's plan was not confirmable and instead proceeded to confirmation of the Marathon plan, which proposed to "transfer" the noteholders' collateral, including more than 200,000 acres of redwood timberlands, to a newco free and clear of the noteholders' liens and without the right of the noteholders to credit-bid. The plan further proposed to pay the noteholders' secured claim the value of their collateral.

After a valuation proceeding in which the bankruptcy court determined that the value of the timberlands was not more than $510 million (well below the amount of the noteholder claims), the bankruptcy court concluded that the plan's proposed payment of that amount to the noteholders constituted the "indubitable equivalent" of the noteholders' claims and, thus, satisfied the fair-and-equitable test under § 1129(b)(2)(A). On appeal, the indenture trustee argued that subsection (ii) of § 1129(b)(2)(A), not subsection (iii), governed a plan providing for

a sale of collateral free and clear of the noteholders' liens and that by failing to afford the noteholders the right to credit-bid, the Marathon plan was not fair and equitable. The Fifth Circuit rejected this argument and affirmed the bankruptcy court's order.

Focusing on the disjunctive nature of the three subsections of § 1129(b)(2)(A), the court found that a plan could be confirmed so long as it met any one of the three subsections' requirements, regardless of whether the plan's structure more closely resembled the type of structure described in another subsection. Thus, the court held that a plan contemplating a sale of property free and clear of liens did not render subsection (ii) (and the presumptive right to credit-bid) imperative provided that the plan offered the realization of the indubitable equivalent of the lienholder's secured claim. According to the court, "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 noteholders' collateral."[8] Notwithstanding the significance of this "if," the court found "no error" in the bankruptcy court's valuation of the noteholders' collateral.

Philadelphia Newspapers Decision

In *Philadelphia Newspapers*,[9] the debtors proposed to sell their business to insiders, subject to competitive bids, as part of a chapter 11 plan. Under the plan, the debtors' prepetition lenders, who were owed approximately $318 million, were to receive approximately $37 million in sale proceeds as well as ownership of the debtors' Philadelphia headquarters, valued at $29.5 million, subject to a two-year rent-free lease in favor of the purchaser plus any additional proceeds generated from the auction. The debtors filed proposed bid procedures, which would have precluded the lenders from credit-bidding. When the bankruptcy court refused to bar the lenders from credit-bidding—finding that the plan was structured as a sale subject to § 1129(b)(2)(A)(ii)—the debtors appealed. The district court reversed. On appeal by the lenders, the Third Circuit affirmed the district court. According to the court, "[w]hile the proposed disposition of assets in subsection (ii) may reflect a special congressional concern about the free and clear transfer of collateral that secures a loan, this does not lead inexorably to the conclusion that Congress meant for subsection (ii) to be the exclusive means through which such collateral is transferred."[10]

Following *Pacific Lumber*'s lead, the Third Circuit observed that Congress' inclusion of the indubitable-equivalence prong intentionally left open the potential for other methods of conducting free-and-clear sales, so long as those methods sufficiently protected the secured creditor's interests. In declining to hold that subsection (iii) is ambiguous, the court found that a plain reading of that subsection compels the conclusion that when a debtor proceeds thereunder, Congress provided secured lenders with no *right* to credit bid at a sale of the collateral. The court made clear that notwithstanding its holding, it expressed no opinion as to whether the debtors' plan *in fact* provided the realization of the indubitable equivalent of the lenders' secured claims. The court offered that the lenders would retain their rights to argue at confirmation that the restriction on credit-bidding failed to generate fair market value at the auction, thereby preventing them from receiving the indubitable equivalent of their claim. (That the secured lender arguably had the burden of proof at confirmation on the issue of "fair and equitable" also likely came as a surprise.)

Noting that the case involved an insider stalking-horse bidder "seeking to pay as little as

possible to obtain the assets 'on the cheap' in a Circuit where secured lenders are allowed to bid up to the full amount of their debt," Judge Ambro took the majority's decision in *Philadelphia Newspapers* to task.[11] The dissent's primary complaint was that the majority had concluded too quickly that § 1129(b)(2)(A) was unambiguous, which, according to Judge Ambro, it was not. The majority had jettisoned context and read the language of the statute to provide a list of three alternatives to cramdown from which the debtor could simply *choose* with respect to any plan.

The dissent posited a more reasonable interpretation of the statute—one that would provide distinct routes to confirmation that apply specific requirements depending not on what a plan proponent *chooses* as its confirmation path, but rather *on how the given plan proposes to treat the claims of secured creditors*. Thus, the dissent argued that subsection (i) applies to all plans under which the debtor proposes to retain or sell collateral to a third party subject to the lien, subsection (ii) applies to all plans under which the debtor proposes to sell the collateral free and clear of liens, and subsection (iii) applies to all other plans that do not fall under subsections (i) and (ii). The dissent observed that applying subsection (iii) to plan sales free of liens notwithstanding the more specific subsection (ii) concerning such sales violated canons of statutory construction that specific provisions prevail over general provisions and that statutes should not be interpreted so as to render one part inoperative or superfluous. The dissent could think of no reason why Congress "would expend the ink and energy detailing procedures in (ii) that specifically deal with plan sales free of liens, only to leave general language in (iii) that could sidestep entirely those very procedures."[12] The majority's "plain language" reading of § 1129(b)(2)(A) also could not be harmonized with other provisions of the Bankruptcy Code, namely §§ 363(k) and 1111(b) (providing, among other things, recourse treatment to nonrecourse lender, except in the case of sale pursuant to § 363 *or a plan*).

Finally, according to the dissent, the majority's reading disturbed the settled expectations of debtors and lenders and skewed the incentives of debtors to maximize benefits for insiders, not creditors. Judge Ambro explained: "If the debtors here prevail, a direct consequence is that debtors generally would pursue confirmation under clause (ii) only if they somehow concluded that providing a right to credit bid as required by that clause would be more advantageous to them than denying that right. This is illogical when one considers that credit bidding is a form of protection for the secured creditor, not the debtor."[13]

River Road **Decision**

With the *River Road* decision, Judge Ambro's dissent had come full circle and a new, or renewed, view of "fair and equitable" treatment of secured creditors emerged. *River Road* also arose in the context of a motion to approve bid procedures that proposed to deny a secured lender's right to credit-bid at a plan sale free and clear of the lender's liens. The bankruptcy court denied the bid procedures, and the debtors appealed. On appeal, the debtors advanced two arguments: (1) the plain language of § 1129(b)(2)(A) requires courts to approve any cramdown plan—including those proposing to sell assets free and clear of liens—that satisfies subsection 1129(b)(2)(A)(iii)'s "indubitable equivalent" requirement, and (ii) a plan that provides a secured creditor with the proceeds from the sale of an asset at an auction that does not permit credit-bidding satisfies the indubitable-equivalence requirement. Embracing Judge Ambro's dissent in *Philadelphia Newspapers*, the Seventh Circuit rejected both arguments. The court held that the Bankruptcy Code requires that cramdown plans that contemplate selling encumbered assets free

and clear of liens at an auction satisfy the requirements set forth in subsection (ii) of the statute.

Like the *Philadelphia Newspapers* dissent, the Seventh Circuit concluded that § 1129(b)(2)(A) is ambiguous, thus requiring the court to apply well-established principles of statutory construction to determine its meaning. In applying those principles, the Seventh Circuit concluded that the debtors' proposed interpretation of § 1129(b)(2)(A)—permitting a plan sale without credit-bidding under subsection (iii) notwithstanding the neighboring Code provision requiring credit-bidding—could not stand as it would render that provision, subsection (ii), superfluous. The court could not "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."[14] Accordingly, the "infinitely more plausible interpretation of section 1129(b)(2)(A)" was to construe each of the subparagraphs as conclusively governing the category of proceedings it addresses.[15]

What sets the Seventh Circuit's decision apart from the Third and Fifth Circuit's decisions is the court's analysis of the "indubitable equivalent." The *Pacific Lumber* court found that a lender realized the indubitable equivalent of its claim when the plan paid the lender in cash the amount of its judicially valued lien. The *Philadelphia Newspapers* court reserved judgment on whether the plan at issue in fact provided the realization of the indubitable equivalent, but nonetheless refused to acknowledge credit-bidding as an essential check against undervaluation. In contrast to those courts, the Seventh Circuit recognized that whether a sale plan provides for the realization of the indubitable equivalent *cannot be determined* when the secured creditor is denied its right to credit-bid. The Seventh Circuit observed that "[d]etermining the value of an undersecured creditor's claim is problematic because it is usually difficult to discern the current market value of the types of assets that are sold in corporate bankruptcies."[16]

However, that valuation problem is only solved by providing lenders with a means to protect themselves from the risk that an auction will not capture the asset's actual value. In enacting §§ 1129(b)(2)(A)(ii) and 363(k), Congress intended to do just that: "[B]y granting secured creditors the right to credit bid, the Bankruptcy Code promises lenders that their liens will not be extinguished for less than face value without their consent." [17] Because doubts about whether an auction produces market value will always exist when the lender is prohibited from credit-bidding, it cannot be said that the value actually realized in such process is the "unquestionable" value of the lender's secured claim. Because nothing in the text of § 1129(b)(2)(A) indicates that plans that *might* (hypothetically) provide secured lenders with the indubitable equivalent of their claims can be confirmed under subsection (iii), the court ruled that that subsection cannot be used to confirm plans that propose auctioning off encumbered assets free and clear without allowing credit-bidding.

Observations

River Road appears to have been decided in a way that preserves (or restores) the balance between debtor and secured creditor interests. The Seventh Circuit understood that to read § 1129(b)(2)(A) to permit a debtor to pick and choose between more restrictive and less restrictive paths to cramdown confirmation is to channel all plans through the less-restrictive path. Surely Congress could not have intended provisions of the Bankruptcy Code whose sole purpose is to protect secured creditors (*i.e.,* to ensure fair and equitable treatment) to be applicable only at the debtor's discretion. Or did they? Neither the Third Circuit nor the Fifth Circuit decisions adequately address that issue. As a policy matter, those decisions also fail to

address the concern raised by Judge Ambro that denying a secured lender its presumptive right to credit-bid at a plan sale arguably benefits no one other than the purchaser desiring to buy assets on the cheap.

The fate of *River Road* (as well as *Philadelphia Newspapers* and *Pacific Lumber*) rests with the Supreme Court, if it is willing to hear the matter. That fate is uncertain. Even Judge Ambro, as critical as he was of the Third Circuit majority's decision, recognized that the majority's reading is "not a trip to the twilight zone."[18] Few would quibble with the proposition that § 1129(b)(2)(A) is not a model of clarity, and the Court may well leave it to Congress to clarify its intent.

1. Although for purposes of simplicity we refer to the Seventh Circuit's decision as the *River Road* decision, the case actually involved two chapter 11 bankruptcy cases and two sets of chapter 11 debtors, the so-called "River Road Debtors," owners of the InterContinental Chicago O'Hare Hotel, River Road Hotel Partners, LLC, River Road Expansion Partners, LLC and other related entities, and the so-called "RadLAX Debtors," owners of the Radisson Hotel at Los Angeles International Airport, RadLAX Gateway Hotel, LLC, RadLAX Gateway Deck and other related entities. The cases involved common legal issues and a common lender agent, Amalgamated Bank, acting on behalf of lender groups for both the River Road Debtors and RadLAX Debtors.

2. The RadLAX Debtors recently petitioned the Supreme Court for *certiorari* review of the Seventh Circuit's decision. *RadLAX Gateway Hotel LLC v. Amalgamated Bank*, 2011 U.S. App. LEXIS 13131, 80 U.S.L.W. 3090 (U.S. Aug. 5, 2011) (No. 11-166). As of the writing of this article, it was not known whether the Court granted *certiorari*.

3. 11 U.S.C. § 1129(a)(8).

4. 11 U.S.C. § 1129(b)(1).

5. *See Cohen v. KB Mezzanine Fund II LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448 (3d Cir. 2006).

6. *See* K. Klee, *All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code*, 53 Am. Bankr. L. J. 133, 155 n. 136 (1979); *In re Kent Terminal Corp.*, 166 B.R. 555, 566-67 (Bankr. S.D.N.Y. 1994) (recognizing lender's right to credit-bid in any free-and-clear sale pursuant to plan best preserved intent of Congress to create stronger creditor safeguards and protections).

7. 584 F.3d 229 (5th Cir. 2009).

8. *Id.* at 247.

9. 599 F.3d 298 (3d Cir. 2010).

10. *Id.* at 308.

11. *Id.* at 320 (Ambro, J. dissenting).

12. *Id.* at 329.

13. *Id.* at 336.

14. 2011 U.S. App. LEXIS 13131, *28.

15. *Id.*

16. *Id.* at *22.

17. *Id.*

18. 599 F.3d at 327.

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