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One Minute Memo®

Seventh Circuit Upholds Secured Lenders' Credit-Bid Rights In Chapter 11 Bankruptcy

The Seventh Circuit recently held that a chapter 11 bankruptcy plan of liquidation is not confirmable over a secured lender's objection if such plan prohibits the lender from credit bidding at a sale of its collateral. In doing so, the Seventh Circuit split with the Third and Fifth Circuit Courts of Appeal which have confirmed plans that block secured creditors' rights to credit bid, potentially making the issue ripe for review by the United States Supreme Court.

Section 1129 of the Bankruptcy Code generally permits confirmation of a chapter 11 plan if each class of impaired creditors votes in favor of the plan. However, a plan may be confirmed (*i.e.*, "crammed down") over one or more dissenting classes of impaired creditors if the plan is "fair and equitable" as to those creditors. With respect to secured creditors, a plan may be considered fair and equitable if it either: (i) permits the dissenting secured creditor to retain its liens; (ii) proposes a sale of the secured lender's collateral free and clear of all liens with such liens to attach to the proceeds of the sale, subject to the lender's right to credit bid; or (iii) provides the secured lender with the "indubitable equivalent" of its secured claim, which serves as a catch-all option. The Bankruptcy Code, however, fails to clarify or limit application of the indubitable equivalent option.

In *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010), the Third Circuit addressed the confirmability of a plan that proposed to provide a secured lender with the indubitable equivalent of its lien through a sale that prohibited the secured lender from credit bidding. The issue was whether the proposed plan was confirmable as a matter of law under the indubitable equivalent option of the "fair and equitable" test even though the proposed plan sale failed to comport with requirements contained in the second option of the test by prohibiting credit bidding.

The Third Circuit agreed with the Fifth Circuit's decision in *In re The Pacific Lumber Co.*, 584 F.3d 299 (5th Cir. 2009), and found that the indubitable equivalent option of the "fair and equitable" test unambiguously permitted confirmation of a plan despite a prohibition on credit bidding. In arriving at this result, the Third Circuit defined indubitable equivalent to mean "the unquestionable value of a secured lender's secured interest in its collateral" - apparently the fair market value of the collateral. However, the court did not address whether the plan actually provided the secured lender with the indubitable equivalent of its lien because the auction sale had not yet taken place. In so ruling, the Third Circuit noted that it is the total compensation provided to a secured lender under a plan, rather than the sale price of the asset alone, that determines whether such lender has received the indubitable equivalent of its lien. In a lengthy dissent, Judge Ambro argued that the Bankruptcy Code was ambiguous on this issue and concluded the Bankruptcy Code's overall scheme and legislative history made clear that a plan may not use the indubitable equivalent option to prohibit credit bidding.

The case of *In re River Road Hotel Partners, LLC*, involved two related debtors who proposed to sell substantially all of their assets at auction sales pursuant to liquidating chapter 11 plans. The debtors requested approval of bid procedures for the auction sales that prohibited credit bidding. The proposed initial auction bids were approximately $100 million below the value of the secured lenders' claims in each instance. The secured lenders objected to the proposed bid procedures. The

Bankruptcy Court for the Northern District of Illinois orally ruled that the prohibition on credit bidding rendered the plans unconfirmable for the reasons stated in Judge Ambro's dissent and denied the bid procedures.

On appeal, the Seventh Circuit adopted much of the reasoning in Judge Ambro's dissent and affirmed the Bankruptcy Court's ruling. *See In re River Road Hotel Partners, LLC*, Case Nos. 10-3597 & 10-3598 (7th Cir. June 28, 2011). Specifically, the Seventh Circuit found the entire three-part "fair and equitable" test, as well as the indubitable equivalent option of the "fair and equitable" test in isolation, to be ambiguous. The court then concluded that permitting a sale to proceed under the indubitable equivalent option without credit-bid protection for a secured lender was impermissible because it violated various canons of statutory interpretation by: (a) rendering other Bankruptcy Code provisions superfluous; (b) conflicting with the objectives of the Bankruptcy Code; and (c) impermissibly allowing general Bankruptcy Code provisions to control over more specific provisions.

The Seventh Circuit also held that a sale of collateral could not independently satisfy the indubitable equivalent option without credit bidding. The court noted that the indubitable equivalent of an undersecured claim is the current market value of the collateral and that, under the Bankruptcy Code, current market value is determined either through judicial valuation or free-market valuation. The Seventh Circuit concluded that the debtors could not satisfy the indubitable equivalent option through a free-market valuation without preserving the secured lenders' credit-bid rights because such rights were otherwise preserved under the Bankruptcy Code and because of the "substantial risk that assets sold in bankruptcy auctions will be undervalued" without credit-bid protection.

These decisions undoubtedly impact strategic bankruptcy planning for both debtors and lenders. Debtors who seek to sell assets under a plan of liquidation will certainly be mindful of these opinions in selecting venue. On the other hand, this split in authority will probably result in lenders: (i) amending loan documents to include contractual rights to credit bid in bankruptcy cases, despite uncertainty regarding the enforceability of such provisions; (ii) challenging debtors' choice of venue; and (iii) recalculating the risk profile and associated costs for providing debtor-in-possession financing.

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