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Lenders' right to credit bid tested before 7th Circuit

BY JASON DEJONKER AND JAMES SOWKA

Given the limited options in today's marketplace to refinance or restructure defaulted or mature commercial mortgage loans, many cash-strapped real estate borrowers have sought relief under the Bankruptcy Code. In a few instances, borrowers have aggressively sought to eliminate or restrict one important right in a secured lender's bankruptcy arsenal — the right to credit bid. Decisions by the U.S. courts of appeals for the 3d and 5th circuits restricting this right have recently emboldened borrowers' attempts to retain commercial real estate investments or steer such investments to related or favorable parties. As discussed below, the 7th Circuit will soon address secured lenders' credit-bid rights in the real estate context.

Credit bidding refers to the ability of a secured lender to bid up to the full amount of its secured debt claim to acquire its collateral (i.e., the mortgaged property in the commercial real estate context) in exchange for cancellation of the related indebtedness in the amount of the bid. A secured lender is not obligated to bid the entire amount of its debt. Credit bidding recognizes circumstances in which a lender may want to acquire its collateral, in exchange for cancellation of the debt, to prevent a borrower from selling such collateral for an inadequate price or an amount insufficient to repay the lender's debt in full. In most circumstances, a credit bid will not include a payment of cash to the borrower. Indeed, allowing a secured lender to credit bid prevents the lender from having to pay cash for its own collateral. Otherwise, the secured lender would simply being paying itself for the foreclosed property.

Before the real estate crisis, an owner of commercial real property had options when its secured mortgage loan came due. Normally, it could find refinancing in the market to take out its secured lender, as real estate financing was generally available and interested lenders were plentiful. Fast-forward to today's market — many lenders have tightened credit terms and lending requirements and have limited the amount of money they are willing to expose to risk in the commercial real estate market. Moreover, many existing commercial real property financings are substantially underwater. With new financing at a premium and many lenders willing to take back their collateral, certain distressed borrowers, particularly single-purpose real estate entities, have explored bankruptcy as a means to force a favorable loan workout.

Previously, single-purpose real estate entities avoided bankruptcy because of certain specific requirements under the Bankruptcy Code that gave less flexibility to single-asset real estate debtors. Furthermore, the results in bankruptcy were often similar to the results in a foreclosure. In state foreclosure court, the lender would either sell the property to a third party or credit bid its debt at a foreclosure sale. Under §§ 363(k) and 1123, the Bankruptcy Code generally preserved similar rights in conjunction with a bankruptcy sale, whether separate from or as part of a Chapter 11 plan. Therefore, if a borrower were unlikely to obtain sufficient value in an arms'-length sale, seeking bankruptcy relief provided it with no additional options, as the lender would still be able to take back its real property collateral through a credit bid.

Recent circuit decisions, however, have concluded that a lender's credit-bid rights can be curtailed in conjunction with a bankruptcy sale conducted through a Chapter 11 plan. See *In re Philadelphia Newspapers LLC*,

599 F.3d 298 (3d Cir. 2010). In *Philadelphia Newspapers*, the 3d Circuit held that Bankruptcy Code § 1129(b)(2)(A) unambiguously permits a debtor to seek confirmation of a Chapter 11 plan that proposes a sale of secured assets free and clear of liens without permitting the affected secured lenders to credit bid, as long as such secured lenders receive the "indubitable equivalent" of their secured interests in the assets. 599 F.3d at 301. The court defined "indubitable equivalent" to mean "the unquestionable value of a lender's secured interest in [its] collateral." Id. at 310. The court noted that a secured lender would be able to challenge confirmation of a plan if the absence of a credit bid denied such secured lender the "indubitable equivalent" of its collateral. In a lengthy dissent, Judge Thomas Ambro argued that Bankruptcy Code § 1129(b)(2)(A) is ambiguous. Therefore, he employed other canons of statutory interpretation and considered the overall structure of the Bankruptcy Code in concluding that secured lenders possess a presumptive right to credit bid at plan auctions.

The 5th Circuit, in an earlier decision, used similar analysis to reach the same conclusion. See *In re The Pacific Lumber Co.*, 584 F.3d 299 (5th Cir. 2009).

Real estate debtors have now sought to apply the Philadelphia Newspapers and Pacific Lumber holdings to attack secured lenders' credit-bid rights in conjunction with bankruptcy sales. This issue is now pending before the 7th Circuit. See *River Road Hotel Partners LLC v. Amalgamated Bank, No.* 10-3597 (7th Cir.), on appeal from the Bankruptcy Court for the Northern District of Illinois. In that case, the bankruptcy court (Judge Bruce Black) certified the issue for direct appeal to the circuit court after denying the debtors' proposed bid procedures because of a proposed prohibition on the secured lenders' presumptive right to credit bid.

River Road involves two debtors that own a hotel and its adjacent meeting facility, both of which serve as collateral for separate secured loans totaling approximately $130 million. Two lenders made each of these secured loans, including a lender syndicate group and the assignee of the Federal Deposit Insurance Corp. (FDIC) under a loss-share agreement. In their bankruptcy cases, the River Road debtors proposed a Chapter 11 plan under which their assets (including the real property) would be sold at auction and the debtors' bankruptcy cases would be substantively consolidated. At the auction, the debtors' secured lenders would not be entitled to credit bid and, absent any competing bids, the debtors proposed to sell the real property for $42 million — nearly $90 million less than the existing secured debt.

To support the elimination of credit-bidding rights, the *River Road* debtors relied heavily upon *Philadelphia Newspapers*. The secured lenders and the FDIC objected, and Black adopted Ambro's lengthy dissent in *Philadelphia Newspapers.* Black also concluded that secured lenders have a presumptive right to credit bid at plan auctions and that the debtors did not establish "cause" to prohibit the secured lenders from credit bidding. Black noted that the debtors failed to establish that the secured lenders breached any of their contractual obligations or to submit any evidence that allowing credit bidding would chill cash bids. Recognizing that his decision ran counter to the circuit court decisions in *Philadelphia Newspaper*s and *Pacific Lumber*, Black certified the issue for direct appeal to the circuit court.

The 7th Circuit's eventual ruling in *River Road* will represent the first circuit court appellate review of the application of *Philadelphia Newspapers* and *Pacific Lumber* in a single-asset real estate case. The decision will have implications in many future proceedings, particularly if the 7th Circuit adopts these decisions in the real estate context. From a practical perspective, if the 7th Circuit follows these decisions, secured lenders may possess fewer rights to protect their interests in bankruptcy vis-à-vis the secured collateral than under state foreclosure law.

Under state law, the lender always has the right to credit bid at a foreclosure sale and take back the mortgaged property in satisfaction of its secured debt unless there is a higher cash bid. The abrogation of secured lenders' right to credit bid is obviously favorable to debtors and provides debtors with additional negotiating leverage. A prohibition on credit bidding could also result in a lower sale price for the real property, either for the debtor or the debtor's favored purchaser, and the potential for a third party to enjoy any equity gains in the real property.

A prohibition against credit bidding could have a significant ramifications for small community banks, syndicated loans, non-bank lenders and the FDIC and its assignees in the event of a bank takeover, as these parties may be unable to make a cash payment in lieu of credit bidding. On the other hand, this issue may have a smaller effect on large banks and lenders that possess sufficient liquidity to submit cash bids equal to the value of their existing liens, as was the case in *Philadelphia Newspapers*. In light of attacks on credit-bid rights, secured lenders should consider amending loan documents to include a contractual right to credit bid in the event of a foreclosure or bankruptcy sale. While the enforceability of such a provision is unclear, inclusion of same would provide lenders with an addition basis to defend credit-bid rights — thereby increasing negotiation leverage and the potential for a positive outcome in bankruptcy court.

Jason DeJonker is a partner, and James Sowka is an associate, in the Chicago office of Seyfarth Shaw. Both concentrate their practices on bankruptcy cases, prebankruptcy workout negotiations and compositions, troubled borrower restructuring and forbearance, and general commercial litigation.