U.S. Supreme Court Holds That Bankruptcy Credit-Bidding May Not Be Denied and Resolves Circuit Split in Favor of Secured Creditors

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The Supreme Court's recent decision in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*[1] settled an important issue to secured creditors including holders of commercial mortgage backed securities. The case confirms that secured creditors facing "cramdown" treatment in a plan of reorganization can credit-bid the balance of the debt in a bankruptcy sale. *RadLAX* settles a circuit split on the cramdown issue and, in today's bleak economic climate, provides a bright spot for secured creditors. It also removes the consideration of multiple issues that could have faced special servicers, such as the ability to make significant cash payments as property protection advances in bankruptcy auctions, had an opposite holding been delivered by the Court.

The story of the *RadLAX* case is not unfamiliar or unlikely. The debtors owned an airport hotel and parking garage, which was pledged as collateral for a $142 million loan. Battered by the tough economy and facing insolvency, the debtors filed for Chapter 11 bankruptcy in 2009. The debtors ultimately proposed a plan of reorganization with a stalking horse bidder that expressly prohibited secured creditors from "credit-bidding" at the auction and, instead, required them to bid cash.

Why does this matter? For secured creditors, bidding cash may be bad business or even impossible. Few creditors desire to sink new money into bankrupt ventures. Plus, creditors have their own cash flow issues and policy limitations that may prevent them from bidding cash in bankruptcy auction.

This sometimes provides third parties with opportunities to acquire properties at auction at deep discounts, forcing secured creditors to content themselves with returns far below the collateral's full value. In contrast, if creditors are allowed to credit-bid, they can step in and bid the amount of their lien.[2] Often, they can take the property without additional cash outlays, thus protecting themselves from being shortchanged by opportunistic third parties.

RadLAX tells us once and for all that, in Chapter 11 plans of reorganization, debtors cannot stop creditors from credit-bidding.[3] But how did we get here? The path begins in Chapter 11 of the Bankruptcy Code[4] and specifically in 11 U.S.C. § 1123 and 11 U.S.C. § 1129.[5] Under Chapter 11, bankruptcy cases follow a "'plan,' typically proposed by the debtor, which divides claims against the debtor into separate 'classes' and specifies the treatment each class will receive. Generally, a bankruptcy court may confirm a Chapter 11 plan only if each class of creditors affected by the plan consents."[6] If creditors do not consent, courts may still confirm the plan—colloquially called a "cramdown" plan — "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims."[7]

To be fair and equitable to a secured creditor, a cramdown plan must satisfy one of three requirements in Bankruptcy Code § 1129(b)(2)(A). That means: (i) the creditor must be able to retain a lien on the property[8]; (ii) if the property is sold free of the original lien, the creditor must be able to credit-bid at the sale or otherwise take a lien on the sale proceeds[9]; or (iii) the plan must provide the secured creditor with the "indubitable equivalent" of its claim[10].

Prior to *RadLAX*, courts disagreed on how to read these requirements. In In re Philadelphia Newspapers, LLC, for example, the Third Circuit Court of Appeals focused on the statute's use of "or" and construed the requirements as alternatives.[11] A debtor could choose one without having to satisfy the others.[12] Even if a debtor conducted a sale (as in subsection (ii)), it need not allow credit-bidding as long as it permitted the secured creditor to receive the indubitable equivalent of its claim (as in subsection (iii)). Cash payouts, liens on real estate, and exchanges of collateral may all serve as indubitable equivalents, meaning creditors had no right to credit-bid if those or other alternatives sufficed.[13]

In reaching this conclusion, the Third Circuit rejected the argument that subsection (ii) — a narrow provision — should control subsection (iii)[14] — a catchall — despite the interpretive canon that specific provisions govern general ones.[15] Looking to *Varity Corp. v. Howe*[16] for support—a Supreme Court case holding that a specific provision of ERISA § 502(a) did not limit a general one — the court said that the Bankruptcy Code provides "no statutory basis to conclude that [subsection (ii)] is the only provision under which a debtor may propose to sell its assets free and clear of liens."[17]

Congress, the court reasoned, may have instead included "the indubitable equivalence prong [of subsection (iii) to] intentionally le[ave] open the potential for yet other methods of conducting asset sales, so long as those methods sufficiently protected the secured creditor's interests."[18] Since they are distinct alternatives, one section cannot govern the other. Furthermore, the court concluded, allowing subsection (ii) to restrain subsection (iii) would cause "an outcome at odds with the fundamental function of the asset sale, to permit debtors to 'provide adequate means for the plan's implementation.'"[19]

Similarly, in In re Pacific Lumber Co., the Fifth Circuit found that secured creditors had no right to credit-bid at a sale.[20] Stressing substance over form, the court read Bankruptcy Code § 1129(b)(2)(A) flexibly, concluding that a debtor need only satisfy one of the three requirements to be fair and equitable. If a debtor's plan provided the creditor with the indubitable equivalent of its claim, the creditor had no right to credit-bid.

Like Philadelphia Newspapers, the court in Pacific Lumber held that the statute's use of "or" meant that it provided debtors with three alternatives.[21] And since the statute prefaced them with the word "includes," the court concluded that these alternatives were "not even exhaustive."[22] There may be times when none of the options provided a fair and equitable result, at which point debtors would need to propose yet other ways to satisfy the Bankruptcy Code.[23] Under Pacific Lumber's facts, the court nevertheless found that the debtor did not need to propose additional options; instead, by paying the secured creditor the cash value of the collateral, the debtor gave it the indubitable equivalent of its claim.[24] This was true, according to the court, even if the secured creditor "forfeited the possibility of later increases in the collateral's value," since the "Bankruptcy Code . . . does not protect a secured creditor's upside potential; it protects the 'allowed secured claim.'"[25]

In issuing their decisions, the Third and Fifth Circuits went against the clear weight of authority at the time. Bankruptcy courts in places as diverse as New York, Florida, California, Oregon, and Pennsylvania had all ruled that Bankruptcy Code § 1129(b)(2)(A) gave secured creditors a right to credit-bid at auction.[26] The New York court in In re Kent Terminal Corp. stated, for example, that "[i]f a plan proposes the sale of a creditor's collateral free and clear of liens, the lienholder has the unconditional right to bid in its lien."[27] Likewise in In re SunCruz Casinos, LLC, the Florida court held that a debtor's attempts to eliminate credit-bidding violated the plain language of § 1129(b)(2)(A)(ii) which expressly gave creditors that right.[28]

The Seventh Circuit agreed with the bankruptcy courts in re *River Road Hotel Partners, LLC,* a 2011 case that declined to follow Philadelphia Newspapers and Pacific Lumber and upheld a secured lender's right to credit-bid when property is sold under § 1129(b)(2)(A). The resulting circuit split helped ensure Supreme Court attention to the matter.

With its decision in *RadLAX*, the Court put an end to the debate. In a unanimous opinion[29] that stands out for its brevity and clarity, the Court stated that secured creditors do have a right to credit-bid based on a simple statutory construction of § 1129(b)(2)(A).[30] Describing the debtors' reading of § 1129(b)(2)(A), as adopted by the Third and Fifth Circuits, as "hyperliteral and contrary to common sense," the Court instead applied the interpretative canon that the specific governs the general — the very canon rejected by the Third Circuit.[31] Noting that § 1129(b)(2)(A)(ii) applies specifically to sales of secured assets while § 1129(b)(2)(A)(iii) applies to all cramdown plans generally, the Court held that subsection (ii) must take effect when there is a sale of secured assets in order to give secured creditors a right to credit-bid.[32] Only when subsection (ii) does not apply will subsection (iii) come into play as an option to provide a secured creditor with the indubitable equivalent of its claim.

Notably, the Court's opinion avoids taking a stand on related bankruptcy issues, such as whether credit-bidding supports the goals of the bankruptcy system.[33] Those issues, the Court says, are for Congress to decide.[34] What the Court does take a stand on is nevertheless important — that secured creditors have a right to credit-bid at bankruptcy auctions. For creditors that want to protect their collateral and keep their cash, this is a decision they can stand behind.

1 *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. ____ (2012).

2 *RadLAX*, 566 U.S. at 3.

3 Id. at 10.

4 11 U.S.C.§ 101 et seq. (the "Bankruptcy Code").

5 See generally 11 U.S.C.§ 1123, 11 U.S.C.§ 1129.

6 *RadLAX*, 566 U.S. at 2.

7 11 U.S.C.§ 1129(b).

8 11 U.S.C. § 1129(b)(2)(A)(i).

9 11 U.S.C. § 1129(b)(2)(A)(ii).

10 11 U.S.C.§ 1129(b)(2)(A)(iii).

11 In re Philadelphia Newspapers, LLC, 599 F.3d 298, 305 (3d. Cir. 2010).

12 Id.

13 Id. at 311.

14 Id. at 307.

15 Id.

16 *Varity Corp. v. Howe*, 516 U.S. 489 (1996).

17 In re Philadelphia Newspapers, LLC, 599 F.3d at 308.

18 Id.

19 Id. at 309 (quoting 11 U.S.C. § 1123(a)(5)(D))

20 In re Pacific Lumber Co., 584 F.3d 229 (5th Cir. 2009).

21 Id. at 245.

22 Id. In particular, the court notes that, "The introduction to § 1129(b)(2) states that the 'condition that plan be fair and equitable includes the following requirements . . . . The Bankruptcy Code specifies that the term 'includes' is not 'limiting.'" Id. (quoting 11 U.S.C. § 102(3)).

23 Id.

24 Id. at 246–49.

25 Id. at 247.

26 In re Matrix Dev. Corp., 2009 WL 2169717 *8 (July 16, 2009 Bankr. D. Or.); In re SunCruz Casinos, LLC, 298 B.R. 833, 839 (Bankr. S.D. Fla. 2003); In re River Village, 181 B.R. 795, 805 (E.D. Pa. 1995); In re Kent Terminal Corp., 166 B.R. 555, 566–567 (Bankr. S.D.N.Y. 1994); In re Orfa Corp. Of Philadelphia, 1991 WL 225985, *6 (October 31, 1991 Bankr. E.D. Pa); H & M Parmely Farms v. Farmers Home Admin., 127 B.R. 644, 648 (D.S.D. 1990); In re 222 Liberty Associates, 108 B.R. 971, 978 (Bankr. E.D. Pa. 1990); In re Realty Investments, Ltd., 72 B.R. 143, 146 (Bankr. C.D. Cal. 1987).

27 Kent Terminal Corp., 166 B.R. at 566–567.

28 In re SunCruz Casinos, 298 B.R. at 839.

29 Kennedy, J. recused.

30 *RadLAX*, 566 U.S. ____ .

31 Id. at 5.

32 Id. at 7, 9.

33 Id. at 10.

34 Id.