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Expert Analysis

River Road Hotel Partners and the Secured Creditor's Right to Credit Bid

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The 3rd U.S. Circuit of Appeals' opinion in *In re Philadelphia Newspapers*, 599 F.3d 298 (2010), and the 5th Circuit's opinion in *Bank of New York Trust Co. v. Official Unsecured Creditors' Committee (In re Pacific Lumber Co.)*, 584 F.3d 229 (2009), shocked the lending community. The decisions were particularly unsettling given the prevalence of credit bidding in today's soft real estate market, and the legitimate expectations secured creditors have to credit bid when their collateral is being sold free and clear of liens in a Chapter 11 case.

With a credit bid, a secured lender offers to waive the balance owed to it in return for the debtor's assets.

First, in *Pacific Lumber* the 5th Circuit held that a reorganization proposing the sale of the debtor's encumbered assets for an amount equal to the judicially determined value of the assets qualified as "fair and equitable" under Bankruptcy Code Section 1129(b)(2)(A)(iii).

Then, in *Philadelphia Newspapers* the 3rd Circuit held that a plan proposing the sale of the debtor's encumbered assets free and clear of liens in an auction where credit bidding would not be allowed could qualify as "fair and equitable" under subsection (iii).

In a much anticipated decision, the 7th Circuit held in *In re River Road Hotel Partners LLC*, 2011 WL 2547615 (June 28, 2011), that a plan of reorganization could not abrogate a secured creditor's right to credit bid in a "free and clear" sale of assets under the plan.

Two of the debtor entities involved in *River Road,* RadLAX Gateway Hotel LLC and RadLAX Gateway Deck LLC, appealed that decision to the U.S. Supreme Court Aug. 5. It remains to be seen whether the justices will grant *certiorari* to resolve the conflicting circuit court decisions.

BACKGROUND

The *River Road* case involved River Road Hotel Partners LLC, River Road Expansion Partners LLC and related entities, which built the InterContinental Chicago O'Hare Hotel and an affiliated event space.

The River Road debtors obtained construction loans totaling $155 million from the Longview Ultra Construction Loan Investment Fund and the Longview Ultra I Construction Loan Investment Fund. Amalgamated Bank was designated as the administrative agent for the lenders.

Several months after the InterContinental Hotel opened in September 2008, the River Road debtors requested several million dollars in additional funding from their lenders to finish construction of the hotel's restaurant and to pay their general contractors and suppliers. The parties entered into negotiations but could not reach agreement under which additional funding would be provided. The River Road debtors filed Chapter 11 petitions Aug. 17, 2009, in the U.S. Bankruptcy Court for the Northern District of Illinois.[1]

The 7th Circuit decision also involved a second case, which was consolidated with the River Road case. That case involved RadLAX Gateway Hotel LLC, owner of the Radisson Hotel at Los Angeles International Airport, which it purchased in 2007.

RadLAX Gateway Hotel and its affiliates obtained a construction loan totaling approximately $142 million from Longview to purchase the hotel, pay for renovations and build a parking structure on an adjacent parcel of land, which was to be owned by a related entity. Amalgamated Bank was designated as the administrative agent for the secured lender.

In March 2009 the RadLAX debtors were forced to cease construction after they ran out of funds. They entered negotiations with Longview regarding additional funding, but the parties could not agree on mutually acceptable terms. The RadLAX debtors also filed Chapter 11 petitions Aug. 17, 2009, in the Northern District of Illinois.[2]

Less than a year later, the River Road debtors and the RadLAX debtors filed their plans of reorganization, which provided for the sale of substantially all their assets free and clear of liens. The debtors also filed motions for approval of proposed bidding procedures, including the approval of "stalking horse" bids in amounts significantly less than the secured indebtedness.

Because the secured lenders did not accept the plans of reorganization, the debtors had to seek confirmation of the plans under the "cramdown" provisions of the Bankruptcy Code.[3]

Amalgamated Bank objected to the bidding procedures and did not assent to the plans. The bank argued that the plans violated Bankruptcy Code Section 1129(b)(2)(A)(ii) because they sought to sell the secured lender's collateral free and clear of their liens without allowing them to credit bid.

The debtors, in turn, contended that the plans were nevertheless confirmable under the "indubitable equivalent" exception contained in Section 1129(b)(2)(A)(iii).[4]

The Bankruptcy Court held that the debtors' plans could not be confirmed and denied the proposed bid procedures, basing its holding on the dissent in *Philadelphia Newspapers*, which held that non-consenting secured creditors whose claims would be crammed down under a reorganization should have a right to bid their credit. The debtors appealed that decision and requested certification of the appeal directly to the 7th Circuit.[5]

LEGAL ANALYSIS

Affirming the Bankruptcy Court's ruling, the 7th Circuit said Section 1129(b)(2)(A) does not authorize a debtor to use subsection (iii) to confirm a reorganization plan that seeks to sell encumbered assets free and clear of liens without providing secured creditors the right to credit bid.

Bankruptcy Code Section 1129 governs the confirmation of Chapter 11 plans. In general, a reorganization plan must be accepted by each class of claimants or leave the non-accepting classes "unimpaired."[6]

Section 1129(b), however, creates an exception to this requirement if the debtor can demonstrate that the plan is "fair and equitable" with respect to each class whose claims are impaired under the plan and who have rejected the plan. That section is known as the "cramdown" provision of the Bankruptcy Code.

Subsection 1129(b)(2)(A) defines what qualifies as "fair and equitable" treatment of secured creditors and states that:

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

The 7th Circuit held that a reorganization plan could not abrogate a secured creditor's right to credit bid in a "free and clear" sale of assets under the plan.

The 7th Circuit's analysis began with the observation that "[a]n increasing number of debtors" have started seeking confirmation of their plans under Section 1129(b)(2)(A)(iii). Determining whether a reorganization plan is "fair and equitable" is difficult, however, because the "language used in this provision is both sparse and general."[7] The court then discussed the two recent circuit opinions analyzing Section 1129(b)(2)(A).

In *Pacific Lumber Co.*, the 5th Circuit held that a reorganization plan that proposed the sale of the debtor's encumbered assets for an amount equal to the judicially determined value of the assets qualified was "fair and equitable" under Section 1129(b)(2)(A)(iii).[8]

In *Philadelphia Newspapers*, a split panel of the 3rd Circuit approved bid procedures that did not permit secured creditors to credit bid at an auction of substantially all the debtor's assets conducted pursuant to the plan of reorganization.

The majority in that case held that a sale "free and clear" could take place pursuant to a plan of reorganization without allowing the lenders to credit bid because the

proceeds of the sale would constitute the "indubitable equivalent" of the secured lender's claims under Section 1129(b)(2)(A)(iii). It came to this conclusion notwithstanding the express reference in subsection (ii) to the right to credit bid in connection with a sale "free and clear" of liens.[9]

The panel in *Philadelphia Newspapers* did not actually decide, however, that the non-credit-bid plan of reorganization at issue could be confirmed under Section 1129(b)(2)(A)(iii). The decision only upheld the debtor's right in that case to seek to do so.

Because the lenders in *Philadelphia Newspapers* subsequently chose to participate in the auction with a cash bid, the question of whether such a plan would provide the secured lenders with the "indubitable equivalent" of their secured claims under Section 1129(b)(2)(A)(iii) remained unresolved.

Judge Thomas Ambro wrote a dissent in *Philadelphia Newspapers*, extensively criticizing the majority's interpretation of the statute.[10] The 7th Circuit in *River Road* wholeheartedly embraced Judge Ambro's reasoning.

The 7th Circuit held that Section 1129(b)(2)(A) does not authorize a debtor to use subsection (iii) to confirm a reorganization plan that seeks to sell encumbered assets free and clear of liens without providing secured creditors the right to credit bid.

The 7th Circuit concluded that, as a matter of strict statutory construction, the debtors' proposed interpretation of subsection (iii) would render subsections (i) and (ii) superfluous. That is because under the debtors' interpretation, subsection (iii) allows a debtor to sell an asset free and clear of liens without permitting credit bidding, thereby rendering subsection (ii) meaningless.

Troubled by such interpretation, the 7th Circuit said, "We cannot 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 abandons these requirements in a subsequent subsection."

The "infinitely more plausible interpretation" of Section 1129(b)(2)(A) would be to read each subsection as "stating the requirement for a particular type of sale and 'construing each of the ... subparagraphs ... [as conclusively governing] the category of proceedings it addresses,'" the panel said, quoting *Bloate v. United States*, 130 S. Ct. 1345, 1355 (2010).[11]

As such, a reorganization plan can gain "fair and equitable" status under subsection (iii) only if it proposes disposing of assets in ways not delineated in subsections (i) and (ii), the panel concluded.

The 7th Circuit further said the debtors' suggested reading of subsection (iii) would undermine the long-standing protections for secured creditors contained in other sections of the Bankruptcy Code.

As Judge Ambro noted in his dissent in *Philadelphia Newspapers*, various provisions of the Bankruptcy Code, such as Sections 363(k), 1129(b)(2)(A)(ii) and 1111(b), are intended to ensure that secured creditors "are properly compensated."[12] In other words, they ensure that lenders can "protect themselves from the risk that the winning auction bid will not capture the asset's actual value," the 7th Circuit said.

This right enables the secured creditor, who might believe that the auction did not accurately reflect the value of its collateral, to take possession of the asset to prevent extinguishment of its lien for less than par without its consent. Such right is significant, and is expected, considering the host of factors that create "a substantial risk that assets sold in bankruptcy auctions will be undervalued," the panel noted.

The River Road and RadLAX debtors' "interpretation of Section 1129(b)(2)(A) would not provide secured creditors with the types of protections that they are generally accorded elsewhere in the Code," the 7th Circuit said.

It concluded that "their interpretation is less plausible than a construction of the statute that reads subsection (ii), which offers the standard protections to creditors, as providing the only way for plans seeking to sell encumbered assets free and clear of liens to obtain 'fair and equitable' status."[13]

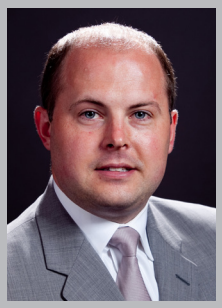
Therefore, the 7th Circuit agreed with the Bankruptcy Court that the debtors' plan could not be confirmed because of its failure to ensure that the secured lenders' interests were properly compensated.[14]

CONCLUSION

The capital markets are grounded in secured lenders' well-established expectations that their collateral will not be sold for less than face value without their consent. Denying secured creditors the right to credit bid under a reorganization plan undermines this inviolate right, as recognized by Judge Ambro in his dissent in *Philadelphia Newspapers* and by the 7th Circuit in *River Road*. Given the importance of the issue, the Supreme Court should agree to hear the *River Road* appeal.

NOTES

1 *In re River Road Hotel Partners LLC*, 2011 WL 2547615, at *1.
2 *Id.* at *1-2.
3 *Id.* at *2.
4 *Id.*
5 *Id.*
6 11 U.S.C. § 1129(a)(8).
7 *In re River Road* at *5.
8 *In re Pac. Lumber*, 584 F.3d at 249.
9 *In re Philadelphia Newspapers*, 599 F.3d at 318.
10 *Id.* at 324-27 (Ambro, J., dissenting).
11 *In re River Road* at *8.
12 *In re Philadelphia Newspapers*, 599 F.3d at 331 (Ambro, J., dissenting).
13 *In re River Road* at *8.
14 *Id.* at *9.

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