

Can Secured Creditors Credit Bid in Chapter 11 Plans? Supreme Court to Decide

By Lawrence Mittman¹ and John D. Penn²

The Issue

The issue is whether a Chapter 11 plan can be crammed down over the secured lender's objection where the plan provides for the sale or transfer of the secured lender's collateral with the proceeds going to the secured lender without the secured lender having the right to credit bid for its collateral up to the full amount of its claim.

The answer to this critical question is split among the circuit courts of appeal that most recently considered the issue. Two circuit courts, including the one that hears appeals from the popular Delaware Bankruptcy Court, have denied secured lenders the right to credit bid when their borrowers-debtors' proposed to sell or transfer real estate as part and parcel of their Chapter 11 plans and force the secured lender to take the proceeds of sale as the "indubitable equivalent" of its claim. One circuit court, more recently, however, recognized the secured lender's right to always be able to credit bid in a plan context involving the sale or transfer of its collateral.

The Supreme Court decided to step in and resolve this split among the circuits in an appeal due to be decided in 2012.

Who Should Be Interested?

Anyone involved in the real estate financing as a borrower or a lender as well as those who might want to purchase real estate from a Chapter 11 debtor should take note of this case.

Discussion

A. Is There a Right to Credit Bid in a Plan Context?

Secured commercial real estate lending in this country is done largely on a non-recourse basis.³ This means, that in the event of a default, the secured creditor only has its mortgage rights against its collateral to recover its indebtedness. Most mortgages, generally speaking, allow a secured lender at a foreclosure sale to "bid-in" up to the full amount of its debt and take ownership of the property, unless the debt is totally repaid, or the lender otherwise voluntarily agrees to accept a lesser sum.

Chapter 11 is a major weapon in the arsenal of a defaulting borrower seeking to prevent a secured lender from foreclosing. In Chapter 11, a secured lender is not only automatically stayed from taking action to enforce its mortgage (including precluding foreclosure), but under certain circumstances can be forced to accept a restructured debt, have its collateral either sold or surrendered to the lender as determined by the bankruptcy court. This process is commonly referred to as "cramdown." As part of a cramdown, over the secured lender's objection, the term of the restructured debt could be extended; the principal amount of the secured creditor's debt could be reduced to equal the amount that the bankruptcy court determined as the value of the collateral; and there could also be a change

¹ Lawrence Mittman is a partner in the New York, NY office of the law firm of Haynes and Boone, LLP. His practice emphasizes reorganization and restructuring. He may be reached at lawrence.mittman@haynesboone.com or 212.659.4977.

² John D. Penn is a partner in the Fort Worth, TX office of Haynes and Boone, LLP. His practice emphasizes bankruptcy. He may be reached at john.penn@haynesboone.com or 817.347.6610.

³ Most loan transactions only provide for recourse in connection with specified "bad acts," such as bankruptcy filings or misappropriation of collateral or proceeds thereof.

of interest rate. Cramdown can also involve the sale of collateral assets or otherwise providing the lender with the indubitable equivalent of its claim.

Does a mortgagee always have the right to credit bid if the borrower-debtor proposes to sell the collateral to a third party in its Chapter 11 case? In Chapter 11, it had generally been held that if a debtor wanted to sell or otherwise dispose of property, the secured creditor could trump the sale by credit bidding in its mortgage debt and take title to the property.

Recently, two circuit courts blocked the ability to credit bid if the proposed sale is part of a Chapter 11 plan.⁴ Taking a very literal reading of the cramdown provision of section 1129 of the Bankruptcy Code, these two circuit courts held that the right of a secured lender to credit bid can be cut off if the debtor proposes to sell real estate as part of a plan that provides the lender with the “indubitable equivalent of its claim” under Section 1129(b)(2)(A)(iii) of the Bankruptcy Code’s cramdown provisions. Thus, a debtor may force a lender to take the “indubitable equivalent”⁵ of its interest in the collateral (the proceeds of a third party sale) under its Chapter 11 plan without the right to credit bid for its collateral.

These two decisions sent shock waves through the commercial real estate lender market. Not surprisingly, real estate borrowers that legally could do so, have looked to file bankruptcy in the six states encompassed by the circuit courts which had denied the secured lender’s right to credit bid in the plan context.⁶

B. Contrary View

This past year, however, the Court of Appeals for the Seventh Circuit declined to follow the rulings of the Third and Fifth Circuits and upheld the right of secured creditors to always credit bid – whenever their collateral was proposed to be sold under a Chapter 11 plan including under the “indubitable equivalent” cramdown.⁷

C. The Supreme Court Steps In

The Supreme Court recently agreed to hear *RadLAX Gateway Hotel, LLC, et al., v. Amalgamated Bank* (Case No. 11-166), and will decide whether the right to credit bid is, in fact, always available to secured lenders in the context of disposition of collateral as part of Chapter 11 cramdown plans or if debtors can circumvent credit bidding by selling collateral in a plan under the indubitable equivalent cramdown provisions of the Bankruptcy Code.

Why Is This Important?

As indicated above, a mortgage lender’s recovery after its borrower’s default is usually limited to its collateral. Whether a secured lender always has the right to credit bid in all circumstances of a sale of collateral under a cramdown plan is of critical importance both to real estate mortgage lenders and borrowers. The Supreme Court’s decision on this issue, expected this summer, will be closely watched, studied and reported upon in a future issue.

⁴ *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009) and *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010).

⁵ This is provided in Section 1129. It is derived from a ruling by the renowned Judge Learned Hand in the case of *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935). Roughly speaking, a secured creditor receives the indubitable equivalent of its claim if the plan provides an asset (including cash, a security, a debt instrument, return of collateral or delivery of other assets) that the Bankruptcy Court determines to be worth at least as much as the lesser of the amount of its debt or the value of its collateral.

⁶ Delaware, New Jersey or Pennsylvania (Third Circuit) and Louisiana, Mississippi or Texas (Fifth Circuit).

⁷ *In re River Road Hotel Partners, LLC and RadLAX Gateway Hotel, LLC*, 651 F.3d 642 (7th Cir. 2011).