ORRICK

RESTRUCTURING ALERT | JUNE 1, 2012

Supreme Court Confirms that Secured Creditors Have a Presumptive Right to "Credit Bid" in a Sale of Their Collateral Conducted Pursuant to a Chapter 11 Bankruptcy Plan

Contact a Team Member

Orrick's Restructuring Group is available to assist clients in addressing questions regarding this alert. For further information, contact:

Raniero D'Aversa
Partner
New York

Jonathan Guy
Partner
Washington, D.C.

James Burke
Managing Associate
Washington, D.C.

On May 29, 2012, the United States Supreme Court issued its much-anticipated decision in the Chapter 11 bankruptcy cases for RadLAX Gateway Hotel, LLC and its affiliate (together, the "Debtors"). The Court held that when a debtor proposes to sell a secured creditor's collateral free and clear of the creditor's lien pursuant to a Chapter 11 bankruptcy plan, the debtor cannot deny the creditor the opportunity to "credit bid" in the sale without cause. This decision resolves what was described to the Court as "[p]erhaps the most hotly debated issue of bankruptcy law today" and is a significant victory for issuers of secured credit.

I. Background

"Credit bidding" is a practice by which a secured creditor can bid in a sale of its collateral and purchase the collateral without coming out of pocket and expending additional funds. In lieu of cash, the creditor is permitted to offset against the purchase price the amount of debt that is still owed to it.

The right to credit bid has long been viewed by secured creditors as an important protection against the risk that their collateral will be undervalued in a distressed sale. If a secured creditor believes that the bids for its collateral are too low, the creditor can always purchase the collateral itself and try, then or later, to resell the collateral at a higher price. Having the right to credit bid enables the secured creditor to attempt this strategy without risking new funds (i.e., throwing good money after bad).

Two provisions of the Bankruptcy Code provide secured creditors with rights to credit bid in a Chapter 11 context. The first provision—Section 363(k)—deals with sales conducted while a bankruptcy case is ongoing. Section 363(k) gives secured creditors a right to credit bid in such a sale "unless the court for cause orders otherwise." The second provision—Section 1129(b)(2)(A)(ii)—deals with sales that will be conducted pursuant to a debtor's bankruptcy plan. To be approved over the objection of a secured creditor, a bankruptcy plan must satisfy a minimum requirement. Section 1129(b)(2)(A)(ii) provides that one way to meet that requirement is to organize a sale of the secured creditor's collateral free and clear of liens and give the creditor the same right to credit bid that it would have under Section 363(k) if the sale were conducted outside of the plan.

II. The RadLAX Decision

In the RadLAX case, the Debtors sought approval of a Chapter 11 bankruptcy plan that provided for the sale of substantially all of the Debtors' assets. The proceeds of that sale were to be distributed primarily to the Debtors' secured lenders. The bidding procedures for the sale, however, denied the secured lenders the right to credit bid for their collateral.

The Debtors acknowledged that, by denying the secured lenders the right to credit bid, their plan did not comply with Section 1129(b)(2)(A)(ii) ("Subsection Two"). The Debtors argued, however, that their plan still could be approved over the secured lenders' objections because the plan instead satisfied Section 1129(b)(2)(A)(iii) ("Subsection Three"). This subsection provides that a second way for a plan to meet the minimum requirement to be approved is for the plan to give secured creditors the "indubitable equivalent" of their collateral. Similar arguments had previously been accepted by the Courts of Appeals for the Third and Fifth Circuits. For further information about these decisions, read an earlier Orrick Client Alert here.

Before the Supreme Court, the Debtors and their secured lenders both advanced several practical and policy-based arguments in favor of their respective positions. Ultimately, however, the Court's analysis focused only on the statutory construction of Section 1129(b)(2)(A). The Court held that because Congress specifically designed Subsection Two to address sales of secured creditors' collateral free and clear of liens under a bankruptcy plan, any plan that provides for such a sale must comply with the requirements of that subsection, including the requirement to allow secured creditors an opportunity to credit bid, and cannot be approved pursuant to the more general terms of Subsection Three.

III. Potential Implications

For secured creditors, the Supreme Court's decision in the RadLAX case reaffirms an important protection against the undervaluation of their collateral. It also harmonizes the rights that secured creditors have in sales conducted pursuant to Chapter 11 bankruptcy plans with the rights that secured creditors have in sales conducted during the bankruptcy case. Additionally, the Supreme Court's decision preserves secured creditors' bargaining leverage vis-à-vis debtors and reduces the threat that debtors will engage in mischief by, for example, attempting to sell secured creditors' collateral to insiders at less than arm's length.

Secured creditors should take note, however, that the Supreme Court's decision is not an absolute guarantee that they will have the right to credit bid in a sale of their collateral. In accordance with Section 363(k), a debtor may still ask the bankruptcy court to deny credit bidding "for cause," whether the sale will be pursuant to a plan or during the case. For this reason, the RadLAX decision likely will not be the last word on credit bidding.

***

To discuss the impact of the RadLAX decision on your business, please contact Raniero D'Aversa, Jonathan Guy, or James Burke.