***River Road*: Credit Bid Freeway or Tollway?**

(By Randy Klein and Jeremy Downs, Goldberg Kohn Ltd.)

In *Matter of River Road et al.*, the Bankruptcy Court for the Northern District of Illinois ruled in connection with bid procedures motions that the Debtors could not use § 1129(b)(2)(A)(iii) (indubitable equivalent test) to sell assets under a plan that did not meet the requirements of § 1129(b)(2)(A)(ii), including its requirement that secured creditors have the right to "credit bid" for such assets. By certification, the Seventh Circuit heard the appeals directly. On June 28, 2011, the Seventh Circuit affirmed the ruling of the Bankruptcy Court that denied the Debtors' request for an order precluding credit bidding in connection with their proposed sale under a plan. In doing so, the Seventh Circuit rejected the Third Circuit's majority in the recent *Philadelphia Newspapers* decision.

"A 'credit bid' is a truncated reference to language in § 363(k) of the Bankruptcy Code that permits the holders of an allowed secured claim to bid at the sale and 'offset such claim against the purchase price.' The concept is set-off of mutual obligations. The purchaser owes the estate and the estate owes the purchaser in its capacity as first priority secured lender. If the purchaser is acquiring fully encumbered collateral, § 363(k) allows for the procedural netting of the amounts." Klein and Juhle, *Majority Rules: Non-Cash Bids and the Reorganization Sale*, 84 Am. Bank. L. J. 297, 317 (2010).

The Debtors in *River Road* sought to preclude their secured lenders from "credit bidding" at the proposed plan sales and requiring them to bid "cash just like every other potential bidder." [Appellant Brief at p. 11]. The Debtors took this approach notwithstanding pertinent language of 1129(b)(2)(A)(ii) stating that a plan is "fair and equitable" if it includes requirements "for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims." Instead, the Debtors argued that the "all cash" sales under the plan will provide the lenders with the "indubitable equivalent" of their claims under Section 1129(b)(2)(A)(iii), and, therefore, 1129(b)(2)(A)(ii)'s protection of credit bidding can be ignored.

However, examination of the parties' 7th Circuit briefs reveal that the "all cash" sales had a catch. The Debtors intended to provide the Lenders "with the indubitable equivalent of their secured claims by paying them cash proceeds from the Plan Sales." Note what the Debtors do not say. The Debtors do not propose to pay the Lender ***all of*** the cash proceeds from the Plan Sales. The Lenders, understandably, attacked this position in their brief, highlighting that "the Debtors proposed to fund, through the proceeds of the Plan Sales … their administrative and priority claims . . . ." [Appellee Brief at 13]. Thus, the Debtors compounded the difficulty of avoiding 1129(b)(2)(A)(ii) by proposing to deduct unrelated auction expenses from the gross sale proceeds – i.e., hoping "indubitable" meant "close enough."

Perhaps the reason for this treatment of the secured lenders is not entirely surprising. The Debtors sought to sell their assets to entities 95% owned by Och-Ziff Real Estate

Acquisitions LP. The other 5% was held indirectly for the benefit of one of the Debtors' principals. The stalking horse asset purchase agreement also provided for the continued management of the hotel properties by entities owned and controlled by one of the Debtors' principals. [Appellee Brief at 14]. These insider benefits were threatened by the real prospect of a credit bid.

Very large teeth for the Debtors' fight with their secured creditors grew from the Third Circuit's recent 3rd Circuit ruling in *Philadelphia Newspapers* allowing debtors to sell assets without affording secured creditors the right to "credit bid," so long as the Debtors otherwise met the indubitable equivalent alternative under 1129(b)(2)(A)(iii). The Debtors, in their opening brief to the 7th Circuit, did not explain how the Debtors would satisfy the indubitable equivalent standard in this case. They simply maintained that they have the absolute statutory right to try to cram-down the secured creditor under 1129(b)(2)(A)(iii) in a sale situation. Importantly, the Debtors also did not explain to the Court why they needed to circumvent credit bidding order to confirm their plans.

Interestingly, the Debtors tried to obfuscate the central legal issue by quoting the following language from the Third Circuit:

> "We are asked here not to determine whether the "indubitable equivalent" would necessarily be satisfied by the sale; rather we are asked to interpret the requirements of § 1129(b)(2)(A) as a matter of law. This distinction is critical. The auction of the Debtors' assets has not yet occurred. Other public bidders may choose to submit a cash bid for the assets…We are simply not in a position at this stage to conclude, as a matter of law, that this auction cannot generate the indubitable equivalent of the Lenders' security interest in the Debtors' assets."

The Debtors urged that the same rule should apply in *River Road*, claiming that denying the credit bid will "foster the rehabilitative goals of the Bankruptcy Code." [Brief at 33]. In short, the Debtors asked the Seventh Circuit to wait until the sales were conducted (without credit bidding) and then let them try to prove, at confirmation, that they have met the indubitable equivalent test. But what does that mean? If the secured creditors are prepared to pay more for their collateral, how can a lesser bid satisfy the indubitable equivalent standard? What would happen to the proceeds of the creditors' bid, if forced to be made in cash, went other than payment to the secured creditor? What if the secured creditor made its "all cash bid" predicated on the requirement that 100% of the proceeds be remitted to satisfy the secured claims on the transferred assets? The Debtors did not propose any answers to these questions.

The Seventh Circuit, unlike the Third Circuit in *Philadelphia Newspapers*, did not avoid the issue of whether the indubitable equivalent standard would be satisfied by the proposed plan sale. Rather, the Seventh Circuit, found "the statutory analysis articulated by Judge Ambro in his *Philadelphia Newspaper* dissent to be compelling." [Op. at 16]. First, the Seventh Circuit concluded that it is possible to read the indubitable equivalent option of Section 1129(b)(2)(A)(iii) to only be applicable to plans that are not otherwise covered by subclause

(i) and, in the case of collateral to be sold under a plan, subclause (ii). In addition, the Seventh Circuit concluded that it would be "problematic" to satisfy the "indubitable equivalent" test in the absence of allowing a secured creditor to "credit bid". Among other reasons, third party transaction costs "will not reflect [the asset's] actual value." [Op. at 19, n. 6.] In *River Road*, for example, the Debtors proposed a break-up fee to the stalking horse that would have been paid from the higher, all-cash bid, thus reducing the compensation to the secured creditor.

Despite taking the bite out of the Third Circuit's ruling, the Seventh Circuit admitted that the Third Circuit's interpretation of 1129(b)(2)(A) was at least plausible. The issue, therefore, was whether one reading of the statute was more compelling than the other. The Seventh Circuit concluded that the Debtors' approach rendered 1129(b)(2)(A)(ii) superfluous, if any debtor simply could try to avoid credit bidding by pursuing confirmation under subclause (iii). [Op. at 22]. The Debtors' argument would put subclauses (ii) and (iii) in conflict and "would allow the general to subsume the specific." [Id. n. 7]. Finally, the Seventh Circuit found that the Lenders' interpretation was consistent with the protection of secured creditors' rights found elsewhere in the Code, including Section 363(k) and Section 1111(b). No sale of collateral under a plan may be "fair and equitable" under Section 1129(b) unless the secured creditor has the right to make a bid and offset its claim against the purchase price. [Op. at 24].

Until the Supreme Court takes a case to resolve the conflict between the Circuits, secured creditors will be better off in the Seventh Circuit than the Third Circuit, at least at it pertains to the essential right to credit bid.