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Credit Bidding, Security, and the
Obsolescence of Chapter 11

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After a detailed examination of the nature of secured credit and the historical evolution of the treatment of secured claims in bankruptcy, this paper first explains why, on the statute as written in 1978, Congress intended for secured creditors to have the right to credit bid in a sale under a cram down plan, and did not intend for that right to be supplanted by an alternative indubitable equivalent treatment. However, the paper then demonstrates how the financial world for which the 1978 Code was written has fundamentally changed, with the rise of dominant secured creditors. That change has upset the balance of power, rendering the Code’s scheme obsolete as regards secured creditors in this context.

The paper then asks what can and should be done, either judicially or legislatively, to address the problem of chapter 11’s obsolescence. As a matter of statutory interpretation, a “faithful” Court should be bound to uphold the secured creditor’s right to credit bid, although a dynamic interpretation might counsel otherwise. Legislatively, the time has come to amend the Bankruptcy Code to reverse the

default rule on credit bidding; suggested Code amendments are offered. Contrary to the virtually unanimous body of scholarly opinion, the paper argues that credit bidding should not presumptively be required. Instead, a secured creditor should be permitted to credit bid only if it makes a specific showing of “cause” to the court, demonstrating how denial of that right would prejudice the secured creditor in the particular case.

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By

CHARLES J. TABB*

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INTRODUCTION

The United States corporate reorganization law, colloquially known as “chapter 11,” is the poster child worldwide of an ideal model law empowering the restructuring of financially distressed firms in a fair and balanced way. Indeed, chapter 11 has enjoyed that almost iconic status ever since it was signed into law by President Jimmy Carter in the fall of 1978.¹ For almost a quarter century after chapter 11 became the law of the land, the reality largely matched the hype.² But, as Chaucer observed long ago,³ all good things must come to an end, and such has been the fate of chapter 11. The carefully crafted chapter 11 scheme of checks and balances, which worked so well for the financial “70s Show,” has become obsolete.

The problem, simply put, is that the financial world has fundamentally changed. The “new wine” of 21st century finance cannot be put in the “old bottle” of the 1978 bankruptcy law.⁴ What were envisioned as critically necessary protections for secured creditors when they were embedded in Jimmy Carter’s reorganization regime may have made sense in a world where secured lenders often enjoyed only limited control over a debtor’s operations and restructuring, and where those secured creditors were potentially at the mercy of and almost inevitably in conflict with a powerful entrenched debtor management, an aggressive equity block, and influential junior creditors.

But that world has passed from the scene just as surely as have bell bottoms, leisure suits, and disco (or so one hopes!). For at least the past decade, the reality is that senior secured creditors often have liens on all the firm’s assets and exercise virtually total control over the debtor’s access to cash, and thus call the shots – before and during bankruptcy – in corporate restructurings.⁵ One shot that those senior secured lenders call repeatedly is to sell the firm’s assets, lock, stock, and barrel, in the incipient stages of the case. Bankruptcy may be little more than a way station visited briefly to cleanse the debtor’s assets in an almost unassailable free and

¹ Pub. L. No. 95-598, 92 Stat. 2549 (1978).

² See, e.g., Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603 (2009).

³ In 1374 Chaucer wrote, “There is an end to everything, to good things as well.” See Gregory Y. Titelman, RANDOM HOUSE DICTIONARY OF POPULAR PROVERBS AND SAYINGS (1996), quoted at http://www.phrases.org.uk/bulletin_board/5/messages/1379.html (consulted March 1, 2012). More recently, Thornton Wilder observed, “All good things must come to an end, but all bad things can continue forever.” See http://www.searchquotes.com/quotation/All_good_things_must_come_to_an_end,_but_all_bad_things_can_continue_forever./9688/ (consulted March 1, 2012).

⁴ Jesus famously told the parable that new wine should not be put into old bottles, lest the bottles burst. See Luke 5:37-38.

⁵ See, e.g., Kenneth Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511 (2009); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003); Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002); David A. Skeel, Jr., *The Past, Present and Future of Debtor-In-Possession Financing*, 25 CARDOZO L. REV. 1905 (2004); David A. Skeel, Jr., *Creditors’ Ball: The “New” New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003).

clear sale from nagging claims.⁶ Traditional “reorganizations” of the sort where the debtor firm, led by old management, spends an extended time in chapter 11 restructuring its business and its financial structure pursuant to a plan hammered out in negotiations with a multitude of creditor and equity stakeholders, have largely passed from the scene.

Newton’s Third Law of Motion teaches that “for every action there is an equal and opposite reaction.”⁷ More informally, common experience suggests that “push back” is a typical response to the application of excessive pressure. In the wake of the brave new world of secured creditor reorganization dominance, we are witnessing a Newtonian “third law” response. Debtor managers, equity holders, and junior creditors have concocted various ingenious schemes and plans that would “interpret” the Bankruptcy Code in creative and innovative ways designed to push back against secured creditor dominance.⁸ Some of these schemes have on occasion found a receptive audience in the federal judiciary.

Perhaps the poster child for this phenomenon is the recent furor over “credit bidding.” In a series of high profile cases, the plan proponent, working in concert with the unsecured creditors’ committee, proposed to “cram down”⁹ senior secured creditors in a free and clear asset sale under a plan without giving those secured creditors the opportunity to make a competing credit bid.¹⁰ Those plans could be described as a Newtonian “third law” push back against the dominance of secured creditors. Ever since the enactment of the Bankruptcy Code in 1978, the received wisdom had always been that in an asset sale, a secured creditor enjoyed the essentially unfettered right to protect its interests against cram down by making a credit bid. This right inhered whether the sale was made under a plan, thus invoking 11 U.S.C. § 1129(b)(2)(A)(ii),¹¹ or outside of a plan, thus triggering § 363(k).

That settled understanding was turned upside down in a pair of court of appeals decisions, first by the Fifth Circuit in the fall of 2009 in the case of *In re The Pacific Lumber Co.*,¹² and then by the Third Circuit the following spring in the case of *In re Philadelphia*

⁶ Ralph Brubaker, *Sales Free and Clear of Liens under Code § 363(f)(3) & (f)(5): Can the Bankruptcy Court Authorize a Free-and-Clear Sale of Overencumbered Property?*, 22 No. 12, BANKR. LAW LETTER 7, 10 (2002).

⁷ See <http://www.physicsclassroom.com/class/newtlaws/u2l4a.cfm> (consulted March 1, 2012).

⁸ For a particularly ambitious effort, but which was rejected by the court, see *In re River East Plaza, LLC*, - F.3d -, 2012 WL 169760 (7th Cir. 2012).

⁹ See Kenneth Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133, 134 (1979) (when agreement with each class of creditors cannot be reached the plan nevertheless may be confirmed over their dissent —“crammed down”— if the debtor meets several requirements in the Code).

¹⁰ Credit bidding allows a lienholder to bid on the encumbered property at the sale and, importantly, to “pay” simply by offsetting its claim against the purchase price, rather than by forking over cold hard cash. See Ralph Brubaker, *Cramdown of an Undersecured Creditor Through Sale of the Creditor’s Collateral: Herein of Indubitable Equivalence, the § 1111(b)(2) Election, Sub Rosa Sales, Credit Bidding, and Disposition of Sale Proceeds*, 29 No. 12 BANKR. LAW LETTER 1 (2009).

¹¹ Charles J. Tabb, *THE LAW OF BANKRUPTCY* 1116 (2nd ed. 2009).

¹² *Scotia Pac. Co. v. Official Unsecured Creditors’ Comm. (In re The Pac. Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009).

Newspapers, LLC.¹³ Those courts concluded that a secured creditor did not have an immutable¹⁴ – or indeed any – right to credit bid in an asset sale, as long as it instead received the “indubitable equivalent” of its claim as valued by the bankruptcy court, under § 1129(b)(2)(A)(iii). It would be an understatement to say that those decisions generated a veritable firestorm of controversy.¹⁵ The tide swung back the other way in the summer of 2011 when the Seventh Circuit rejected the approach of the Third and Fifth Circuits in *In re River Road Hotel Partners, LLC*,¹⁶ holding instead that a secured creditor’s right to credit bid could not be taken away by a judicial estimation of indubitable equivalence. The Supreme Court has granted certiorari in the *River Road* case, styled before the Court as *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*.¹⁷

The specific issue of credit bidding thus will be settled (perhaps) by the Supreme Court, for good or ill. In this paper I will explain why *on the statute as written*, I believe that the Court should affirm the Seventh Circuit and uphold the secured creditor’s right to credit bid in an asset sale, and reject the contrary “indubitable equivalence” alternative embraced by the Fifth and Third Circuits. That conclusion only follows, though, on the assumption that the Court is bound to apply the statute on the most faithful understanding of the intention Congress sought to express at the time of enactment.

But the larger problem is this: that statute was written in 1978, and it no longer works as intended in this context. The world of inter-creditor and creditor-debtor dynamics that the delicate statutory balance speaks to has changed. The reality is that the plans put before the Fifth, Third, and Seventh Circuits, and the statutory reading adopted by the Third and Fifth Circuits, push back against the new regime of secured creditor dominance. Viewed in that light, is the “creative” interpretation embraced in *Philadelphia Newspapers* and *Pacific Lumber* defensible? More broadly, how should the courts apply obsolete statutes? Should the Bankruptcy Code be recalibrated to reflect the modern reality, rather than a quaint historical era? If so, how?

Part I examines the statutory scheme of checks and balances established in the 1978 Bankruptcy Code regarding the treatment of secured claims in reorganizations generally and asset sales particularly. To do so, that part looks first at the nature of secured credit and then turns to an historical exegesis, with an assessment of the foundational Depression-era cases on

¹³ *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010).

¹⁴ “Immutable,” that is, unless the court orders otherwise for “cause.” See 11 U.S.C. § 363(k), and *id.* § 1129(b)(2)(A)(ii) (incorporating § 363(k)). Courts have been very sparing in their interpretation of what qualifies as sufficient cause to deny credit bidding.

¹⁵ See, e.g., Jason S. Bookner, *Pacific Lumber and Philadelphia Newspapers: The Eradication of a Carefully Constructed Statutory Regime Through Misinterpretation of Section 1129(b)(2)(A) of the Bankruptcy Code*, 85 AM. BANKR. L.J. 127 (2011); Brubaker, *supra* note 10; Anthony Sexton, *Indubitably Uncertain: Philadelphia Newspapers and the Role of Valuation Uncertainty in Attempted Cramdown of All-Equity Plans*, 28 EMORY BANKR. DEV. J. 55 (2011).

¹⁶ *River Road Expansion Partners v. Amalgamated Bank (In re River Road Hotel Partners LLC)*, 651 F.3d 642 (7th Cir. 2011), *cert. granted*, *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 845 (2011).

¹⁷ *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 845 (2011).

secured claims in bankruptcy. It then explains why the 1978 scheme was structured as it was, driven by a perceived need to protect secured creditors from a particular form of potentially prejudicial treatment. In Part II I examine the recent cases grappling with the credit bidding issue, and explore the phenomenon of the credit bidding furor. Part III then chronicles the rise of dominant secured creditors, and how that development has upset the balance of power in the Code, arguably rendering the Code obsolete as regards secured creditors in this particular setting. Part IV then asks what can and should be done, either judicially and legislatively, to address the problem of the Code's obsolescence. I conclude that a "faithful" Court would be bound to reverse the default rule. Contrary to the virtually unanimous tide of scholarly opinion, I assert that credit bidding should *not* presumptively be required. Instead, a secured creditor should be permitted to credit bid only if it makes a specific showing of "cause" to the court, demonstrating how denial of that right would prejudice the secured creditor in the particular case.

I. SECURITY RIGHTS IN BANKRUPTCY AND THE ORIGINAL UNDERSTANDING

The fundamental entitlement of secured creditors – in or out of bankruptcy – is to be paid in full, up to the value of their collateral, in priority to unsecured creditors.¹⁸ Indeed, this entitlement is quintessentially definitional; the very nature of "secured" debt is that the creditor who enjoys the protection of that security for its debt can have the secured property applied to satisfy the debt if the debtor otherwise fails to pay. Unsecured creditors, by definition, lack this protection, and will be able to collect their debts only out of the residue of the debtor's assets after collateral is applied to satisfy secured claims. But nothing about having security gives a secured creditor any protection above and beyond the *value* of that collateral. I loan you \$1,000, and ask you to pledge your watch to me as collateral for that debt. You default, but I discover that the watch is worth only \$200. The sad reality is that my secured protection and priority over unsecured creditors is only \$200, that being the value of my collateral, the watch. For the remaining \$800 of my debt, I am in the same lowly boat as the other unsecured creditors.

Nothing about the debtor being in bankruptcy changes this practical, definitional limitation on the reach, meaning, and impact of security, or gives the creditor holding the right to that security any enhanced rights. Bankruptcy does not create secured claims,¹⁹ nor does it provide a venue for an alchemy by which collateral values magically grow. Collateral is worth what it is worth, and whatever it is worth defines the amount of the creditor's "allowed secured

¹⁸ See Tabb, *supra* note 11, at 735; Charles J. Tabb & Ralph Brubaker, *BANKRUPTCY LAW PRINCIPLES, POLICES AND PRACTICE*, 283 (3rd ed. 2010).

¹⁹ Tabb, *supra* note 11, at 737.

claim.”²⁰ In the watch hypothetical, I have a \$200 secured claim, and an \$800 unsecured claim – in bankruptcy or out of bankruptcy. Bankruptcy cannot make a Timex a Rolex.

The trick in bankruptcy, though, and the source of much of the trouble that the credit bidding tempest highlights, is figuring out how to allow secured creditors to *realize* the value of their collateral. This point is critical, because value is neither self-actualizing nor eternally constant. Something has to happen to enable the secured creditor to capture that value. How and when that something happens can make a very big difference. If I held a mortgage in south Florida in 2012 I would not be in a rush to foreclose, because home property values have collapsed; perhaps in a year they will have risen, possibly even dramatically, and I might thus prefer to wait to foreclose. Or say that I have that lousy Timex watch as collateral; how, exactly, will it come to pass that its worth is applied to defray the debt owed to me? Outside of bankruptcy, the normal procedural means by which the secured creditor can realize on its security is by “foreclosing” on the collateral – i.e., by repossessing the collateral and selling it. Importantly, though, outside of bankruptcy the secured creditor by and large has the privilege of dictating when and how the foreclosure takes place, and thus can seek to maximize its collateral value. Furthermore, when its collateral is being sold, the secured creditor normally has the privilege of bidding its own debt at the sale and purchasing the collateral itself – i.e., a “credit bid,” thus protecting the secured creditor from what it believes to be too low a sale price.²¹ These non-bankruptcy collateral realization rules, however, are premised on the protection of the secured creditor vis-à-vis the debtor only, *viz.*, as a two-party problem.

Much of the *raison d’être* for bankruptcy law, though, is to help solve collective action problems.²² That is, when bankruptcy is in play, the norm is that third parties—indeed, many, many third parties—are involved, and have a stake in the maximum realization of value from the debtor’s assets. If the secured creditor were given full rein to maximize its collateral value as it saw fit, subject only to “commercially reasonable” constraints affecting no one but the debtor, other stakeholders might lose value in the debtor’s assets as a whole. Those whose stake is lower on the distributional food chain (e.g., unsecured creditors, equity) may favor strategies regarding the deployment of the firm’s assets, including the secured creditor’s collateral, in opposition to those that the secured creditors might favor. If it is in the best interests of the secured creditor to move quickly to foreclose, lower-ranking parties may have exactly the opposite incentive, and vice versa. The elusive quest is to figure out how to allow junior stakeholders to obtain maximum value without harming the secured creditor’s collateral value or exposing the secured creditor to unfair risks in collateral value realization.²³ At the very least, though, in bankruptcy

²⁰ 11 U.S.C. § 506(a)(1) (2005). Postpone for now consideration of the qualification to this rule that follows when the creditor makes the “1111(b)(2)” election. See notes – *infra* and accompanying text.

²¹ See U.C.C. § 9-610(c) (2010); Grant Gilmore, SECURITY INTERESTS IN PERSONAL PROPERTY 1242 (1965).

²² Tabb, *supra* note 11, at 4.

²³ For example, the flaw in the *River East* case, *supra* note 8, 2012 WL 169760 (7th Cir. 2012), was precisely that the debtor sought to transfer risk to the secured creditor by substituting a different sort of collateral. The Seventh

the presumptive non-bankruptcy entitlement of the secured creditor to determine exactly *how* and *when* it will realize its collateral value may be overridden if necessary to protect the interests of competing stakeholders. The only inalienable right secured creditors enjoy is to the “value” of their collateral. As Justice Douglas observed in a leading Depression-era case, discussed below: “Safeguards were provided to protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property. There is no constitutional claim of the creditor to more than that.”²⁴ In a predecessor case, the Court concluded that the secured creditor did not enjoy a constitutional right to decide *when* the sale would take place, or to control the collateral during the bankruptcy case.²⁵

The oft-quixotic balancing quest plays out in bankruptcy in two distinct temporal perspectives. One such perspective is the temporary, interim period during the pendency of the bankruptcy case; the second is the final and permanent fixing of rights upon exit from bankruptcy. The policy determination has been to accord less than total protection to secured creditors during the interim period, but to insist upon “completely compensatory”²⁶ treatment in the final resolution.²⁷ Thus, during the pendency of a case, a secured creditor is automatically stayed from exercising its non-bankruptcy foreclosure rights,²⁸ and may even have to return to the estate collateral that it had properly repossessed prior to bankruptcy.²⁹ In exchange for relinquishing its non-bankruptcy procedural rights for realizing on the collateral, the secured creditor’s core bankruptcy entitlement is to receive “adequate protection” under § 361.³⁰ The essence of adequate protection is to protect the secured creditor from a decrease in the value of its collateral caused by the imposition of the bankruptcy case.³¹ That this interim protection may be less than fully compensatory is demonstrated most starkly by the fact that the secured creditor is *not* entitled to compensation as part of adequate protection for the loss of the time value of the putative foreclosure proceeds.³²

Upon final exit and fixing of rights, however, complete compensation of the secured creditor for its collateral is required. This final fixing of rights in the collateral may take place

Circuit accordingly held that the debtor’s plan did not provide the secured creditor with the “indubitable equivalent” of its allowed secured claim under 11 U.S.C. § 1129(b)(2)(A)(iii), and thus could not be confirmed.

²⁴ *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273, 278 (1940).

²⁵ *Wright v. Vinton Branch*, 300 U.S. 440 (1937).

²⁶ *Metro. Life Ins. Co. v. Murel Holding Corp. (In re Murel Holding Corp.)*, 75 F.2d 941, 942 (2nd Cir. 1935).

²⁷ *Tabb*, supra note 11, at 1158-59.

²⁸ 11 U.S.C. § 362(a)(4) (2010).

²⁹ *See* 11 U.S.C. § 542(a) (1994); *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 211 (1983) (holding that the IRS must return property, recovered properly pre-petition, back to the estate)

³⁰ *See Whiting Pools*, 462 U.S. at 211, 212; *Tabb*, supra note 11, at 302.

³¹ *See Bankers Life Ins. Co. of Neb. v. Alyucan Interstate Corp. (In re Alyucan Interstate Corp.)*, 12 B.R. 803, 807 (Bankr. D. Utah 1981) (discussing the purpose of adequate protection is to protect any impairment in the value of property attributable to the automatic stay); *Tabb*, supra note 11, at 304.

³² *See United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assoc., Ltd.*, U.S. 365, 375 (1988) (holding undersecured creditors are not entitled to compensation for the lost opportunity costs for any delay of proceedings); *Tabb*, supra note 11, at 309.

either during the pendency of the case or at the end, via confirmation of a reorganization plan or in a liquidation distribution. Consider the different means by which that collateral value may be finally realized in the bankruptcy.³³ Essentially there are three basic possibilities: (1) the debtor (or a transferee) keeps the collateral; (2) the collateral is sold; or (3) the collateral is returned to the secured creditor to do with it what it wishes.

Taking the last option first, the secured creditor may be empowered to realize on its collateral in accordance with non-bankruptcy law by getting the collateral back, with the collateral no longer subject to the constraints of the bankruptcy case. That then would free up the secured creditor to foreclose on the collateral however it might prefer, subject only to the constraints of applicable non-bankruptcy laws. There is little legitimate complaint that the lienholder can make if its collateral is surrendered to it; it bargained for nothing more. This return could be effected in various ways: the stay could be lifted, allowing the secured creditor to repossess and foreclose;³⁴ the collateral could be abandoned to the creditor;³⁵ in a liquidation, the trustee is given the power directly to return the property to a secured creditor, if such is not done under any other provision;³⁶ or in a reorganization plan, a secured creditor can be bound to the plan notwithstanding its dissent (i.e., be “crammed down”) if the debtor surrenders the collateral to the secured creditor. As to the last point, chapters 12 and 13 plainly provide that one of the three options for dealing with a secured claim in order to confirm a plan is for the debtor to surrender the collateral to the holder of the secured claim.³⁷ Chapter 11’s cram down surrender rule is more oblique, being cast in terms of the holder of the secured claim receiving the “indubitable equivalent” of its secured claim,³⁸ but the legislative history makes clear that “[a]bandonment of the collateral to the creditor would clearly satisfy indubitable equivalence.”³⁹

At this juncture, and before considering more fully the other two options (retention and sale), let me explain in more detail the parameters of the chapter 11 plan confirmation scheme as applied to secured creditors. Simply, the holder of a secured claim will be bound only if it accepts (or is deemed to accept) the plan, or if it is “crammed down.” Secured claims will be classified, and normally each holder of a secured claim will be placed in its own class, since no other claim would be “substantially similar,”⁴⁰ and then allowed to vote on the plan. If the secured class accepts the plan,⁴¹ or is unimpaired and thus conclusively deemed to accept,⁴² that

³³ Tabb, *supra* note 11, at 742.

³⁴ *See* 11 U.S.C. § 362(d) (2010); Tabb, *supra* note 11, at 743.

³⁵ *See* 11 U.S.C. § 554(a) (2010); Tabb, *supra* note 11, at 743-44.

³⁶ *See* 11 U.S.C. § 725 (1984); H.R. Rep. No. 95-595, at 382 (1977); S. Rep. No. 95-989 at 96 (1978) (the legislative history makes clear that Congress contemplated the return of collateral to a secured creditor).

³⁷ 11 U.S.C. § 1225(a)(5)(C) (2005); 11 U.S.C. § 1325(a)(5)(C) (2010).

³⁸ 11 U.S.C. § 1129(b)(2)(A)(iii) (2010).

³⁹ *See* 124 Cong. Rec. H 11,104 (daily ed. Sept 28, 1978); 124 Cong. Rec. S 14,421 (daily ed. Oct. 6, 1978).

⁴⁰ *See* 11 U.S.C. § 1122(a) (1978); Klee, *supra* note 9, at 150-51.

⁴¹ 11 U.S.C. § 1129(a)(8)(A) (2010).

⁴² *See* 11 U.S.C. §§ 1129(a)(8)(B), 1124 (2010); Klee, *supra* note 9, at 139-40, 154 (under the Code as enacted in 1978, a class would be unimpaired if it was paid the full amount of the allowed claim in cash on the effective date of

is the end of the matter, and if the plan is otherwise confirmed, the secured creditor is bound to the accepted treatment.⁴³ “Cram down” is triggered only if the secured class rejects the plan.⁴⁴

If the secured class is impaired and votes against the plan, and if the plan proponent nevertheless wishes to confirm the plan, the proponent may move for “cram down” under § 1129(b). The overarching cram down test is that “the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.”⁴⁵ For a class of secured claims, the meaning of the “fair and equitable” test is spelled out in detail in § 1129(b)(2)(A). It is in the interpretation of this section that the credit bidding controversy has erupted. Section § 1129(b)(2)(A) lists three options:⁴⁶ first, that the debtor (or a transferee) *retain* the collateral, with the secured creditor retaining a lien on the collateral, and receiving payments over the life of the plan with a present value equal to the amount of the allowed secured claim;⁴⁷ second, that the collateral be *sold* free and clear, subject to § 363(k) (the section that entitles a secured creditor to make a credit bid at a sale of its collateral, unless the court for cause orders otherwise), with the secured creditor’s lien attaching to the proceeds of the sale and with the lien on those proceeds being dealt with under the first or third option;⁴⁸ *or*⁴⁹ that the secured creditor realize the “indubitable equivalent” of its secured claim.⁵⁰ The credit bidding debate is whether, when the collateral is being sold, the secured creditor is always entitled to invoke the second option, and thus presumptively retain the right to make a credit bid, or whether alternatively the plan proponent can deny the secured creditor the right to credit bid and cram it down via the “indubitable equivalent” third option, even in a sale.⁵¹

To fully appreciate the original understanding of these three options when the Bankruptcy Code was enacted in 1978, an historical excursus is vital. The first stop on the history tour is a visit to a trilogy of Depression-era cases affecting the rights of secured creditors;⁵² the second is a notorious chapter XII decision out of Georgia handed down as the Code was being crafted in

the plan. 1124(3)(A) in original Code (repealed)); Tabb, *supra* note 11, at 1115 (for an undersecured class, that meant only that the holder of the secured claim was entitled to be paid the value of its collateral, that being the amount of its allowed *secured* claim. 506(a)). Complications following from the § 1111(b)(2) election are considered below.

⁴³ The same principle holds in chapter 12 and chapter 13 cases. One of the three cram down options in those chapters is for the holder of the secured claim to accept the plan. *See* 11 U.S.C. § 1225(a)(5)(A) (2005); 11 U.S.C. § 1325(a)(5)(A) (2010).

⁴⁴ 11 U.S.C. § 1129(b)(1) (2010).

⁴⁵ *Id.*

⁴⁶ Tabb, *supra* note 11, at 1115.

⁴⁷ 11 U.S.C. § 1129(b)(2)(A)(i) (2010).

⁴⁸ 11 U.S.C. § 1129(b)(2)(A)(ii) (2010).

⁴⁹ The use of the disjunctive “or” between the second and third options has been at the center of the credit bidding controversy, as will be explained below.

⁵⁰ 11 U.S.C. § 1129(b)(2)(A)(iii) (2010).

⁵¹ Brubaker, *supra* note 10.

⁵² *See Louisville Joint Stock Land v. Radford*, 295 U.S. 555, (1935); *Wright v. Vinton Branch*, 300 U.S. 440 (1936); *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273 (1940).

the 1970s;⁵³ and the final leg of the journey is to see how the Code drafters responded to the concerns raised by the Georgia case, in light of the constitutional standards established in the Depression cases.

The foundational case, the continuing vitality of which is the subject of some debate,⁵⁴ was *Louisville Joint Stock Land Bank v. Radford*,⁵⁵ in which the Supreme Court in 1935 struck down § 75 of the first Frazier-Lemke Act⁵⁶ on the ground that it took “from the [mortgagee] without compensation, and [gave] to Radford, rights in specific property which are of substantial value, ... without just compensation,”⁵⁷ in violation of the Fifth Amendment. The Frazier-Lemke Act was passed in the summer of 1934, in the depths of the Depression, and provided a complex scheme by which a farmer could retain and had the exclusive option to purchase his farm – at its appraised value – over a period of up to five years, without the mortgagee’s consent.⁵⁸ By its terms the Act applied only to mortgages entered into *before* the Act was passed, and the Court expressed no opinion as to the constitutionality under the Bankruptcy Clause of applying the Act against subsequent mortgages.⁵⁹ Instead, the Court held the Act unconstitutional under the Fifth Amendment,⁶⁰ as applied against preexisting mortgages, because it took from the mortgagee a bundle of five rights under state law.⁶¹

Just three months and a day after the Court handed down *Radford*, Congress enacted a very slightly revised version of the Frazier-Lemke Act,⁶² and in short order a challenge to the revised Act went before the Court; the mortgagee, unsurprisingly, argued that *Radford* mandated

⁵³ *In re Pine Gate Assoc., Ltd.*, 1976 WL 359163 (Bankr. N.D.Ga.1976), *aff’d*, 1976 WL 359641 (N.D. Ga. 1976).

⁵⁴ James Steven Rogers, *The Impairment of Secured Creditors’ Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Case*, 96 HARV. L. REV. 973 (1983). *But see* United States v. Sec. Indus. Bank, 459 US 70, 75-78 (1982).

⁵⁵ *Radford*, 295 U.S. 555.

⁵⁶ Frazier-Lemke Farm-Mortgage Act (Agricultural Debt Relief Act), ch. 869, 48 Stat. 1289 (1934), codified at 11 U.S.C.A. § 203(s) (1934).

⁵⁷ *Radford*, 295 U.S. at 601-02.

⁵⁸ *Id.* at 576. (Frazier-Lemke Act provided appraisal rights to farm debtors, and for the debtor’s purchase of encumbered farm at appraised value with mortgagee’s consent, or for debtor’s retention of possession for five years with option to purchase at any time at appraised or re-appraised value, subject to payment of reasonable rental fixed by court, held void as depriving mortgagee of property rights without compensation)

⁵⁹ *Id.* at 589.

⁶⁰ The opinion is not entirely crystalline as to whether the precise Fifth Amendment infirmity was a transgression of the Takings Clause or the Due Process Clause; parts of the opinion can be cited in support of either reading. *See* Rogers, *supra* note 54. The Court in subsequent opinions has read *Radford* as both a Due Process case, *see* *Wright v. Vinton Branch*, 300 U.S. 440, 457 (1937), and as a takings case, *see* *United States v. Sec. Indus. Bank*, 459 U.S. 70, 75-76 (1982).

⁶¹ The rights taken were: (1) The right to retain the lien until the indebtedness thereby secured is paid. (2) The right to realize upon the security by a judicial public sale. (3) The right to determine when such sale shall be held, subject only to the discretion of the court. (4) The right to protect its interest in the property by bidding at such sale whenever held, and thus to assure having the mortgaged property devoted primarily to the satisfaction of the debt, either through receipt of the proceeds of a fair competitive sale or by taking the property itself. (5) The right to control meanwhile the property during the period of default, subject only to the discretion of the court, and to have the rents and profits collected by a receiver for the satisfaction of the debt. *See Radford*, 295 U.S. 594, 595.

⁶² Ch. 792, 49 Stat. 942, amending 11 U.S.C.A. § 203(s) (1935).

a similar holding of unconstitutionality. In *Wright v. Vinton Branch*,⁶³ the Court, though, upheld version 2 of Frazier-Lemke, emphasizing first that under *Radford* “[i]t was not held that the deprivation of any one of these rights would have rendered the Act invalid, but that the effect of the statute in its entirety was to deprive the mortgagee of his property without due process of law.”⁶⁴ Version 2 of Frazier-Lemke preserved for the mortgagee, the Court believed, the substance of rights 1, 2 and 4,⁶⁵ and modified to some extent rights 3 and 5,⁶⁶ and then held that the aggregated total of that more limited degree of impairment of the mortgagee’s security did not contravene the Constitution: “the provisions of subsection (s) make no unreasonable modification of the mortgagee’s rights; and hence are valid.”⁶⁷ The bottom line from *Vinton Branch* was twofold; first, and most broadly, *some* modification of the mortgagee’s security was constitutionally permissible in bankruptcy; and second, the debtor might be allowed to redeem the collateral from the mortgagee at an appraised price, at a time potentially of the debtor’s choosing. However, due to some of the language in *Vinton Branch*, it remained unclear whether at some point in time a public sale, at which the mortgagee had the right to credit bid, remained a constitutional necessity.⁶⁸

That possibly still-restrictive view of the extent of the constitutional freedom to modify liens under the Bankruptcy Clause became less tenable when James Wright’s case went back before the Supreme Court three years later in the last of the Depression-era triad of cases, *Wright v. Union Central Life Insurance Co.*⁶⁹ Justice Douglas’s 1940 decision in *Union Central* remains the Court’s controlling word on the nature and extent of the constitutional rights of secured creditors in bankruptcy, and I believe undermines any serious argument that a lienholder enjoys a constitutional right to make a credit bid. After the Court in *Vinton Branch* upheld the facial validity of the revised Frazier-Lemke Act, Wright’s case returned to the lower courts for implementation. James sought to redeem his farm at the appraised value of \$6,000, even though the debt to the mortgagee was almost \$16,000. The lower courts denied the debtor that opportunity, and held that the mortgagee had the right to insist upon and to bid at a public sale.⁷⁰ The Supreme Court reversed, holding that “the denial of an opportunity for the debtor to redeem at the value fixed by the court before ordering a public sale was error.”⁷¹ Even if the mortgagee were denied the right to insist upon a public sale at which it can bid, and instead the debtor were allowed to redeem at an appraised price, the Court concluded that “the creditor will not be

⁶³ 300 U.S. 440 (1937).

⁶⁴ *Id.* at 457.

⁶⁵ *Id.* at 458-59. Those were the rights to retain the lien, to realize upon the collateral at a public sale, and to bid at that public sale.

⁶⁶ *Id.* at 460-61, 465-68. The impaired rights were to determine the time of sale and to control the property during the period of default.

⁶⁷ *Id.* at 470.

⁶⁸ *Id.* at 458-59.

⁶⁹ 311 U.S. 273 (1940).

⁷⁰ *Wright v. Union Cent. Life Ins. Co. (In re Wright)*, 108 F.2d 361 (7th Cir. 1939).

⁷¹ 311 U.S. at 277.

deprived of the assurance that the value of the property will be devoted to the payment of its claim ... [f]or ... if the debtor did redeem pursuant to that procedure, he would not get the property at less than its actual value.”⁷² The controlling constitutional baseline was announced by the Court: “Safeguards were provided to protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property. There is no constitutional claim of the creditor to more than that.”⁷³

Under *Union Central* and *Vinton Branch*, then, a secured creditor does not have a constitutional right to decide if or when the collateral will be sold, to control the collateral pending the sale, or to counter the redemption of the collateral at a judicially appraised price by insisting on submitting a competing bid at a public sale. It is hard to see how the secured creditor’s right to credit bid would rise to constitutional significance if the debtor chooses instead to sell the collateral to a third party rather than to redeem the property itself, assuming that the bankruptcy court makes a judicial determination that the sale price accurately values the collateral, just as it must do in a redemption case. Indeed, the debtor would not run afoul of the Constitution if it redeemed the collateral at a price set by the court and then turned around and sold the property; since it is the first step that fixes the lienholder’s recovery, eliminating the intervening step can hardly be constitutionally significant. While the Court has emphasized a policy preference for open market testing of collateral values, most recently in *203 North LaSalle Street Partnership*,⁷⁴ nothing in the Court’s opinions suggests that its policy preference is constitutionally mandated.

Furthermore, the relatively modest constitutional limits spelled out in *Union Central* applied to bankruptcy legislation imposed on *preexisting* liens; the Court noted that the power under the Bankruptcy Clause to affect liens taken *after* enactment of the bankruptcy legislation might well be much broader.⁷⁵ Thus a “no credit bidding” statute applied against *subsequent* liens would almost certainly be valid; the prospective lienholder would have full advance notice of the bankruptcy risk of credit bidding denial, and that bankruptcy regime would be read into the lien contract. With enactment of the Bankruptcy Code now well over three decades in the past, fewer and fewer modern lienholders can insist upon even the modest protections of *Union Central* and *Vinton Branch*.

Stated otherwise, then, the debtor constitutionally may pick the time when it wants to either redeem or sell the collateral, and may redeem or sell without competition from the secured creditor, at a price set by the court or at auction. Just such a redemption scenario played out in a

⁷² *Id.* at 279.

⁷³ *Id.* at 278.

⁷⁴ *Bank of America Nat’l Trust & Savs. Assn. v. 203 North LaSalle St. P’ship*, 526 US 434 (1999).

⁷⁵ See *Louisville Joint Stock Land v. Radford*, 295 U.S. 555, (1935); *Wright v. Vinton Branch*, 300 U.S. 440 (1936); *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273 (1940); *United States v. Sec. Indus. Bank*, 459 U.S. 70, 75-76 (1982).

notorious 1976 bankruptcy court decision out of Georgia, *In re Pine Gate Associates*.⁷⁶ This chapter XII case, which helped set the stage for the 1978 Code's treatment of secured claims in chapter 11, involved the following controversy: the debtor sought to confirm a chapter XII plan that provided for "the first mortgagee creditors by appraising the value of their security and paying them said amount in cash. The first mortgagee creditors contend that § 461(11)(c) cannot be used to confirm the Plan of Arrangement over their objections unless they are paid the full amount of their debts."⁷⁷ Renowned Bankruptcy Judge William Norton concluded that the debtor could confirm the plan by paying the mortgagee only the value of the collateral at its appraised price, and, reviewing the trilogy of cases just discussed, that such was constitutionally valid:

The *Union Central* case makes it clear that the value of the property (i.e., appraisal by the court) is the full amount the secured creditor can constitutionally claim. A secured creditor is "constitutionally" entitled to payment of nothing more than the actual value of the security. Here, the Debtor may "constitutionally" redeem its property from the debt of the secured creditor by paying to it the actual value of the apartment project.

These decisions establish that there is no magic in a judicial sale, and that a judicial sale is not the only method of determining value of property, and that any reasonable method of ascertaining such an appraisal is constitutionally permissible, so long as the creditor is accorded procedural due process and receives the value of the debt.⁷⁸

Thus, to confirm the plan over the secured creditor's dissent, the *Pine Gate* court held that debtor need not pay the full debt (\$1,454,421.14), but only the lower appraised value, which in a subsequent opinion the court fixed at \$1,032,000 – about 70% of the total debt.⁷⁹ Furthermore, the debtor had the power to pick the time at which it would file bankruptcy and seek the appraisal remedy, and the secured creditor did not have the power to bid against the appraisal. All of this passed constitutional muster.

Pine Gate caused quite a stir when it came down, as secured creditors paled at the thought of being forced to accept a cash out as full compensation for their collateral at a time when the market might be temporarily depressed, and at a price fixed by a bankruptcy judge whose sympathies might favor the debtor, without even having the chance to submit a competing bid. Thus a debt of almost a million and a half dollars could in the blink of an eye be wiped away by a cash payment of just over a million. What if the market were to bounce back quickly?

⁷⁶ *In re Pine Gate Assoc., Ltd.* (Great Nat'l Life Ins. Co. v. Pine Gate Assoc., Ltd.), 1976 WL 359641 (N.D. Ga. Oct. 20, 1976).

⁷⁷ *Id.* at *3.

⁷⁸ *Id.* at *16.

⁷⁹ *In re Pine Gate Assoc., Ltd.*, 1977 WL 373416 (N.D.Ga. Apr. 15, 1977).

What if the judge were wrong in the value he fixed? All too bad, since the debtor would own the property free of the creditor's lien.

Conveniently for secured lenders, when *Pine Gate* came down Congress was in the middle of an extended, comprehensive review and overhaul of the nation's bankruptcy laws. What better chance for secured creditors to set things right than to go straight to the legislature, while it was already thinking bankruptcy thoughts, and get written directly into the new statute the kinds of protections they wanted against the sort of low-ball cram down ignominy that *Pine Gate* wrought? And that is precisely what happened. The secured creditor lobby asked for, and got, a detailed scheme enacted in chapter 11 that was designed to prevent *Pine Gate* redux. The basic mechanisms for this protection are twofold: the secured creditor plan confirmation cram down rules in § 1129(b)(2)(A), and the § 1111(b) election, as explained below.

Before *Pine Gate*, the draft bills being considered in the reform process offered secured creditors no more than *Union Central* required;⁸⁰ no credit bid or election rights were included. All that a secured creditor could insist upon was the value of its collateral, as had been the case under § 216(7) of Chapter X.⁸¹ Thus, for example, § 7-303(7) of the draft bankruptcy act proposed by the 1973 National Bankruptcy Review Commission⁸² allowed cram down if the plan “provide[s] for payment in cash of the value of the claims of any class of creditors which is materially and adversely affected by and does not accept the plan or for such method of protection as will, under and consistent with the circumstances of the particular case, *equitably and fairly provide for the realization by them of the value of their claims.*”⁸³ Nor did the Commission Bill give secured creditors the right to credit bid when their property was sold, whether in a liquidation (§ 5-203)⁸⁴ or in a reorganization (§ 7-205).⁸⁵

⁸⁰*Hearings Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. On the Judiciary: Hearings on S. 235 & 236, 94th Cong. 10 (1975) (prepared statements from the Commission) (“Secured creditors would not be able to veto a plan but would be able to insist on full protection of their rights as measured by value of their collateral.”).*

⁸¹ Section 216 of the prior Bankruptcy Act, enacted in 1938 as part of the Chandler Act, ch. 575, 52 Stat. 840 (1938), governed the required terms of a chapter X plan:

A plan of reorganization under this chapter-- ... (7) shall provide for any class of creditors which is affected by and does not accept the plan ... adequate protection for the realization by them of the value of their claims against the property ... (a) by the transfer or sale, or by the retention by the debtor, of such property subject to such claims; or (b) by a sale of such property free of such claims, at not less than a fair upset price, and the transfer of such claims to the proceeds of such sale; or (c) by appraisal and payment in cash of the value of such claims; or (d) by such method as will, under and consistent with the circumstances of the particular case, equitable and fairly provide such protection.

⁸² REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 93-137 (1973). The Commission on the Bankruptcy Laws of the United States was formed to “study, analyze, evaluate, and recommend changed in the substance and administration of the bankruptcy laws of the United States.” See Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468; Kenneth N. Klee, *Legislative History of the New Bankruptcy Law*, 28 DEPAUL L. REV. 941, 943 (1979).

⁸³ H.R. 10792, 93d Cong. § 7-303(7) (1973).

⁸⁴ H.R. 10792, 93d Cong. § 5-203 (1973).

⁸⁵ H.R. 10792, 93d Cong. § 7-203 (1973).

However, when *Pine Gate* was decided, the game changed. Witnesses at the endless Congressional hearings sounded the battle cry against perpetuating the approach embodied in that decision.⁸⁶ Congress listened. Indeed, the very next bill proposed by the Senate included the right for a secured creditor to credit bid in a sale (under § 363(e) of the proposed legislation), though at that time no similar provision existed in the confirmation context.⁸⁷ Legislative statements underscored the concerns; the suggested remedy to *Pine Gate* was to allow credit bidding for undersecured property.⁸⁸

In the next bill, credit bidding appeared not only for pre-confirmation sales, but also in the confirmation setting, under a § 1129 cram down.⁸⁹ A few months later, a statement in the Congressional Record indicated that “the problems of the recent *Pine Gate* case which has given lenders pause in making real estate loans will be solved by the addition of specific guidelines as to the manner in which real estate loans can be dealt with in reorganization cases.”⁹⁰ Finally, the House and Senate came together on the current protective scheme, which was signed into law by President Carter on November 6, 1978 as the Bankruptcy Reform Act of 1978.⁹¹ Let us examine what that scheme provides.

Above I highlighted the confirmation dance with secured creditors: accept the plan or be crammed down. Cram down under § 1129(b)(2), recall, offers three choices: retention of the collateral by the debtor or a successor, making payments with a present value equal to the “allowed secured claim,” and allowing the creditor to keep its lien on the collateral;⁹² sale free and clear, with the lienholder having the right to credit bid, and its lien attaching to the proceeds of the sale;⁹³ or giving the creditor the “indubitable equivalent” of its claim,⁹⁴ which might include, among other possibilities, surrender of the collateral to the secured creditor.⁹⁵ How do these choices respond to *Pine Gate*?

⁸⁶ *Hearings on S. 2266 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 95th Cong. 528-29 (1977) (statement of Edward J. Kulik, Senior Vice President, Real Estate Division, Massachusetts Mutual Life insurance Co.) (“Any legislation which codified the *Pine Gate* results or makes the situation worse would have the gravest results”).

⁸⁷ S. 2266, 95th Cong. (1977).

⁸⁸ *Hearings on S. 2266 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 95th Cong. 726 (1977) (statement of John Creedon, Executive Vice President of Metropolitan Life Insurance Co.).

⁸⁹ S. 2266, 95th Cong. (1978). Witnesses before Congress suggested that “a similar right to bid be preserved in the event of any sale at the time of or in connection with confirmation.” *Hearings on S. 2266 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 95th Cong. 399 (1977) (statements of Robert J. Grimmig, Vice President of Chemical Bank & John W. Ingraham, Vice President of Citibank).

⁹⁰ 124 Cong. Rec. S14,718-45 (daily ed. Sept. 7, 1978) (statement of Sen. Wallop).

⁹¹ Pub. L. No. 95-598, 92 Stat. 2549 (1978).

⁹² 11 U.S.C. § 1129(b)(2)(A)(i) (2010).

⁹³ 11 U.S.C. § 1129(b)(2)(A)(ii) (2010).

⁹⁴ 11 U.S.C. § 1129(b)(2)(A)(iii) (2010).

⁹⁵ See 124 Cong. Rec. H 11,104 (daily ed. Sept 28, 1978); 124 Cong. Rec. S 17,421 (daily ed. Oct. 6, 1978).

At first blush one might glance at the first option – retention of the collateral by the debtor (or successor) and payment at a judicially appraised price – and think that *Pine Gate* lives. Recall the simple facts of that case: debt equal to a bit over \$1.4 million, collateral valued at about \$1 million. So, under the current law, can't the debtor just cram down the secured creditor under § 1129(b)(2)(A)(i) by cashing it out with a nifty million-dollar payment, leaving the balance of over \$400,000 looking in from out in the cold? Only if the secured creditor lets it. The secured creditor can block this cash-out strategy by making the “§ 1111(b)(2) election.”⁹⁶ If the creditor so elects, then “notwithstanding section § 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.”⁹⁷ What does that mean, in plain English? The “allowed secured claim” of the electing creditor would be not just the million-dollar collateral value, but the full \$1.4 million amount of the total debt.

That matters because the cram down option for retained collateral, under subsection (i) of § 1129(b)(2)(A), has *two* payment requirements: the “principal amount” test and the “present value” test. The principal amount test is that the *total* of all payments made to the secured creditor under the plan must at least equal “the allowed amount of such claim.”⁹⁸ If the creditor makes the §1111(b)(2) election, that amount is the \$1.4 total debt. So if the debtor wanted to cash out the secured creditor *immediately*, it would have to hand over not just a million dollars, but would have to pay a total equal to the entire debt of \$1.4 million – and that kills off *Pine Gate*'s ghost, just as Macbeth would have liked to have been rid of Banquo.⁹⁹

Furthermore, the creditor's lien that it must retain on the collateral secures the entire \$1.4 million principal amount.¹⁰⁰ That rule offers substantial succor to the secured creditor if the debtor defaults under the plan, attempts to refinance, or later sells the property before completing plan payments.¹⁰¹ For example, assume that instead of an immediate cash out, the plan proposes payments over 10 years. In year two the debtor defaults and the secured creditor repossesses, and sells the property at foreclosure for \$1.2 million – a full \$200,000 more than the appraised amount fixed by the court the year before (maybe property values went up, or maybe the court erred). With the § 1111(b)(2) election, “the allowed amount of such claims” that the secured creditor's lien secures under § 1129(b)(2)(A)(i)(I) is the principal amount debt of \$1.4 million, meaning that the creditor gets to keep all of the money. But for the election, if the secured debt had been written down by appraisal to just a million dollars, the creditor would have to remit the \$200,000 surplus to the debtor.

⁹⁶ Tabb, *supra* note 11, at 1162-63.

⁹⁷ 11 U.S.C. § 1111(b)(2) (2010).

⁹⁸ 11 U.S.C. § 1129(b)(2)(A)(i)(II) (2010).

⁹⁹ In Shakespeare's *Macbeth*, the title character murders Banquo, and then later (in Act 3, scene 4) is haunted by Banquo's ghost.

¹⁰⁰ 11 U.S.C. § 1129(b)(2)(A)(i)(I) (2010).

¹⁰¹ Tabb, *supra* note 11, at 1163.

Note, though, that this seemingly wondrous application of the “principal amount” test that follows from an § 1111(b)(2) election does *not* mean that secured creditors are somehow now always entitled to full compensation even if they are undersecured, and that is because of the second payment test, the “present value” test. That test provides that the “deferred cash payments” made under the plan must be “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.”¹⁰² In our example, that means that the payments made to the creditor, which we just learned must *total* \$1.4 million if the creditor made the § 1111(b)(2) election, nevertheless need only have a *present value* as of the plan’s effective date equal to the collateral’s appraised value, *viz.*, of just a million dollars. So a debtor can keep the collateral and make payments over an extended period of time and cram down the secured creditor by paying only the appraised value, in “present value” dollars; it just cannot cash out the creditor quickly for that lesser sum, given the limits of the principal amount test. If the debtor does not default or try to sell or refinance the collateral, but instead completes payments to the crammed down creditor as originally proposed in the confirmed plan, the fact that the secured creditor had a lien securing the full principal amount is irrelevant, because the force of the lien would never be triggered. Notably, too, a creditor who makes the § 1111(b)(2) election thereby forfeits its unsecured deficiency claim (on these facts, equal to \$400,000), and thus would have to weigh the cost of that forfeiture against the benefits of blocking immediate cash out and retaining a full-debt lien.

However, in one important situation, a secured creditor is not allowed to make the § 1111(b)(2) election, and that exception is central to our credit bidding controversy: the election cannot be made if “*such property is sold under § 363 of this title or is to be sold under the plan.*”¹⁰³ Again taking this statutory provision at first blush, it would appear that the specter of a *Pine Gate* low-ball cash-out has made a Lazarus-like reappearance; it is just that the debtor needs to process the cash-out through a sale rather than through a retention with redemption. So, in our continuing example, if the property were *sold* in the case (either during the case, pursuant to § 363, or in a cram down plan, pursuant to § 1129(b)(2)(A)(ii)) and at said sale brought just a million dollars (so the judge was right after all!), then the secured creditor would get just that million dollars in sale proceeds. The creditor cannot elect under § 1111(b)(2) to have its “allowed secured claim” treated as if it were \$1.4 million, because we now know that in fact the collateral really was only worth \$1 million, and the collateral is now gone, having been sold.

But here is the rub, and it is why I believe that the original understanding in 1978 was that Congress did intend for a secured creditor to have the right to make a credit bid if its collateral is being sold (unless the court for cause orders otherwise): the fundamental protection for a secured creditor in that situation is to show up at the sale and submit its own bid if it does

¹⁰² 11 U.S.C. § 1129(b)(2)(A)(i)(II) (2010).

¹⁰³ 11 U.S.C. § 1111(b)(1)(B)(ii) (2010). This rule applies to recourse creditors. For nonrecourse creditors, the right to have the entire claim treated as recourse is eliminated when the collateral is sold. See 11 U.S.C. § 1111(B)(1)(A)(ii) (2010).

not think that the bidding at the sale is bringing what the collateral is actually worth. Nor is this conclusion my unsubstantiated post-enactment musing about what I think Congress might have been thinking back in 1978: the drafters of the Code said as much! In the joint floor statements made by the bill's sponsors contemporaneous with enactment of the 1978 Bankruptcy Reform Act (which was the equivalent of a conference report for the Code¹⁰⁴), they explained the § 1111(b)(2) sale exclusion as follows:

Sale of property under section 363 or under the plan is excluded from treatment under section 1111(b) *because of the secured party's right to bid in the full amount of his allowed claim at any sale of collateral* under section 363(k) of the House amendment.¹⁰⁵

In the same vein, Professor Klee, who as a legislative staffer was one of the principal drafters of the 1978 Act, explained in an article written just after passage of the law that “a class of claims is ineligible to make the election if the holders have recourse against the debtor and the collateral is sold” because “[t]he recourse creditor will be able to bid in its claim when the collateral is sold,” whether the sale occurs under § 363 or the plan.¹⁰⁶

When I suggested above in discussing our ongoing example that “we now know that in fact the collateral really was only worth \$ 1 million,” that factual assumption can more readily be embraced if the secured creditor also had the chance to show up at the sale and bid. Or, stated otherwise, if the creditor chooses not to submit a competing bid, it can hardly complain about the price brought at the sale; it can, and will, complain, though, if barred from participating in the sale.

In enacting the 1978 Bankruptcy Code, the evidence, both from the text itself and even more from the history, strongly suggests that Congress intended that the secured creditor would have the mostly immutable¹⁰⁷ right to submit a credit bid when its collateral is being sold free and clear. The interrelationship between the retention and sale options, and the impact and application of the § 1111(b)(2) election in each instance, reveals a coherent and integrated scheme; allowing a sale of the collateral without offering a credit bid opportunity, as the Fifth¹⁰⁸ and Third Circuits¹⁰⁹ held, would be at odds with the intended operation of the statutory regime.

¹⁰⁴ Klee, *supra* note 9, at 139-44. 124 Cong. Rec. H 11,103 (daily ed. Sept 28, 1978); 124 Cong. Rec. S 14,420 (daily ed. Oct. 6, 1978).

¹⁰⁵ See 124 Cong. Rec. H 11,104 (daily ed. Sept 28, 1978); 124 Cong. Rec. S 14,420 (daily ed. Oct. 6, 1978) (emphasis added).

¹⁰⁶ Klee, *supra* note 9, at 153 n.127.

¹⁰⁷ Section 363(k) does give the court the power to deny the secured creditor the right to submit a credit bid “for cause.”

¹⁰⁸ Bank of New York Trust Co. NA v. Official Unsecured Creditors' Committee (*In re Pacific Lumber Co.*), 584 F.3d 229 (5th Cir. 2009).

¹⁰⁹ *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010).

The Court has made clear that taking such a holistic view of the entire Code is necessary and appropriate in interpreting the Bankruptcy Code.¹¹⁰

In sum, the original understanding when the Code was enacted in 1978, I submit, was that the three secured creditor cram down options in § 1129(b)(2)(A) were intended to be applied in the alternative, depending on what action the debtor proposed to take with regard to the collateral, *viz.*, if the debtor were retaining the collateral, then subsection (i) would govern; if the debtor proposed to sell the collateral, then subsection (ii) (which contains the credit bid provision) would apply; and if the debtor proposed any other course of action, such as surrendering the collateral or substituting new collateral, then the third and final option – “indubitable equivalent” – would control.¹¹¹ Nothing suggests that the indubitable equivalent provision was ever viewed as an always available alternative method of dealing with collateral in the event one of the specifically covered paths (retention or sale) was taken, but instead was included only to fill in the residual gap when something *other* than retention or sale was proposed. In that way, as a policy matter secured creditors would enjoy substantial protection against *Pine Gate*-like debtor-controlled low-ball cash outs.

My view, though, is that this conclusion reflects nothing more than a *policy* decision by Congress, in light of the then-perceived balance of power between debtors and secured creditors. The statutory choices made in 1978, including the seeming right for lienholders to credit bid at a collateral sale, are not constitutionally required. The secured creditor is entitled only to the value of its collateral,¹¹² and there is no inherent reason why a non-credit bid sale cannot yield that value. The only issues, then, are whether the policy choices reflected in the 1978 Code still make sense today, and if not, what can be done about it.

II. THE CREDIT BIDDING FUROR

From the time the Bankruptcy Code was enacted in 1978 until September 29, 2009, it was taken as a given that if a secured creditor’s collateral were to be sold, then the secured creditor had a right to credit bid. As the preceding Part explained, there is little doubt that such was the original understanding.¹¹³ If the sale were to take place prior to the plan, then § 363(k) provided the credit bid right, subject only to being taken away for “cause,” and if the sale were to occur under the plan, then cram down of the secured creditor likewise required preserving the credit bid option, under § 1129(b)(2)(A)(ii). The cram down scheme for secured creditors depended on what was proposed to be done in the plan with the collateral: if the debtor (or its successor) were retaining the collateral, then subsection (i) of § 1129(b)(2)(A) applied; if the collateral were to be sold, then subsection (ii) applied; and if any other treatment of the collateral

¹¹⁰ *United Savings Ass’n of Texas v. Timbers of Inwood Forest Assoc., Ltd.*, 808 F.2d 363 (5th Cir. 1987).

¹¹¹ *See* Brubaker, *supra* note 10; *see also Philadelphia Newspapers*, 599 F.3d at 319 (Ambro, J., dissenting).

¹¹² *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273, 278 (1940).

¹¹³ Tabb, *supra* note 11, at 1116.

were contemplated (e.g., surrender to secured creditor, substitution of replacement collateral), then subsection (iii) governed, requiring that the proposed treatment provide the secured creditor “indubitable equivalent” of its secured claim.¹¹⁴

This orderly view of the world was turned upside down in the fall of 2009 when the Fifth Circuit issued its opinion in *In re Pacific Lumber Co.*¹¹⁵ In that case, the Fifth Circuit held that a secured creditor class that votes against the plan and whose collateral is sold under the plan does *not* have a right to submit a competing credit bid, as contemplated by § 1129(b)(2)(A)(ii), but instead may be crammed down in the alternative under subsection (iii), upon receipt of the “indubitable equivalent” of its allowed secured claim. That indubitable equivalent, the Fifth Circuit concluded, may be determined by a judicial valuation of the collateral, even in a sale.¹¹⁶

The facts in *Pacific Lumber* are complex, but the essence of the plan there as contested on appeal proposed the sale of certain collateral – 200,000 acres of prime redwood timberland – that secured a \$740 million claim for a class of Noteholders.¹¹⁷ Rather than being structured as an auction at which the Noteholders could submit a credit bid, the sale was to be made to newly created entities controlled by the plan proponents (Marathon Structured Finance and Mendocino Redwood Company, a competitor the debtor).¹¹⁸ The Noteholders were to receive \$513 million in cash from this sale; the bankruptcy court, after extensive valuation testimony, had valued their collateral at \$510 million.¹¹⁹ The plan was crammed down over the Noteholders’ dissent on the ground that the \$513 million payment in cash of the appraised value of the collateral constituted the “indubitable equivalent” under § 1129(b)(2)(A)(iii) of the Noteholders’ “allowed secured claims” – the extent of which, as noted, was determined by judicial appraisal, rather than by an open market sale.¹²⁰

The primary objection the Noteholders raised was that since the plan proposed a sale of their collateral, as a matter of law they could only be crammed down *under subsection (ii)* of § 1129(b)(2)(A), which gives them the privilege to submit a credit bid; resort to subsection (iii)’s “indubitable equivalent” test, and cram down by payment of the appraised value, simply is unavailable in a sale case, they asserted.¹²¹ In addition, they objected to the valuation itself, which they argued should have been much higher.¹²² Indeed, the reason they were upset is that

¹¹⁴ Brubaker, *supra* note 10.

¹¹⁵ Bank of New York Trust Co. NA v. Official Unsecured Creditors’ Committee (*In re Pacific Lumber Co.*), 584 F.3d 229 (5th Cir. 2009). Prior to the Fifth Circuit decision, only one published opinion in 30 years had held the same way. See *In re Criimi Mae, Inc.*, 251 B.R. 796, 807-08 (Bankr. D. Md. 2000).

¹¹⁶ *Pacific Lumber*, 584 F.3d at 248-49.

¹¹⁷ *Id.* at 237.

¹¹⁸ *Id.*

¹¹⁹ As courts are wont to do, the bankruptcy court basically split the difference between the valuation amounts suggested by the dueling experts (\$425-430 million by the plan proponent’s expert, \$575-605 million by the Noteholders’ expert). See *id.* at 248.

¹²⁰ *Id.* at 249.

¹²¹ *Id.* at 245-47.

¹²² *Id.* at 247-49.

they preferred to have the option to take the timberlands themselves (which they believed were already worth more than appraised, but even if not, likely would soon appreciate) rather than settle for a cash out payment of \$513 million. If they had been permitted to credit bid, they could have bid up to their \$740 million debt, and thus surely would have been the winning bidders. If the property in fact were worth more in line with what the secured creditors' experts testified (\$575 to \$605 million), then they were entitled to – and via a credit bid could obtain – that value. In a nutshell, the Noteholders had the same basic complaint that secured creditors had raised in the wake of *Pine Gate* – it was unfair to them to be cashed out at a judicially appraised price without the chance to compete for the collateral. That such an ignominy was inflicted on the Noteholders *even when their collateral was being sold* was the proverbial unkindest cut of all.¹²³

The linchpin of the Fifth Circuit's analysis was that since the three subsections in § 1129(b)(2)(A) “are joined by the disjunctive ‘or,’ they are alternatives.”¹²⁴ The Noteholders' plea that denying a credit bid right in a sale case would render subsection (ii) superfluous was rejected by the court both facially and as applied; while *if* a credit bid option were included in a plan, subsection (ii) might then be imperative, such was not the case here because the plan offered an alternative basis for satisfying the secured claim, *viz.*, a cash payment equal to the value of the secured claim.¹²⁵ The court insisted that “Congress did not adopt indubitable equivalent as a capacious but empty semantic vessel.”¹²⁶ Instead, “what is really at stake in secured credit” is “repayment of principal and the time value of money,”¹²⁷ and while subsections (i) and (ii) explicitly protect those twin requirements, “[i]ndubitable equivalent is ... no less demanding a standard than its companions.”¹²⁸ Critically, the court concluded that the proposed plan “obviated both of the bases for protection by offering cash allegedly equal to the value of the Timberlands.”¹²⁹

The heart of the court's reasoning – *and the crux of the lienholders' lament* – is summed up by the Fifth Circuit in the following observation: “Whatever uncertainties exist about indubitable equivalent, paying off secured creditors in cash can hardly be improper if the plan accurately reflected the value of the Noteholders' collateral.”¹³⁰ The “if” clause is, of course, precisely the rub:¹³¹ secured creditors hate judicially appraised cash outs, and pushed for the shape of the Code in the wake of *Pine Gate*, precisely because they do not think that judicial

¹²³ William Shakespeare, *The Tragedy of Julius Caesar* (from Marc Antony's speech in Act 3, scene 2, speaking of Brutus).

¹²⁴ *Pacific Lumber*, 584 F.3d at 245.

¹²⁵ *Id.* at 246.

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.* at 246-47.

¹³⁰ *Id.* at 247.

¹³¹ William Shakespeare, *The Tragical History of Hamlet, Prince of Denmark*. (“To die –to sleep. To sleep – perchance to dream; ay, there's the rub! For in that sleep of death what dreams may come, when we have shuffled off this mortal coil, must give us pause.”)

valuations “accurately reflect” the value of their collateral, but instead are systematically undervalued. But, as I explained above, there is little question that the views of the Fifth Circuit as to the required treatment of a secured creditor’s claim surmounts the low constitutional bar announced by the Supreme Court in *Union Central*.

The court then went on in detail to justify why it believed that the bankruptcy court’s valuation was amply supported by the evidence.¹³² Nor did the court believe that the Supreme Court’s decision in *203 N. LaSalle Street Partnership*¹³³ somehow always *required* a market-based valuation (which a largely inviolable credit bid right would further) in preference to a judicial valuation.¹³⁴ Thus, in the final analysis, the *Pacific Lumber* court held that the plan, “insofar as it paid the Noteholders the allowed amount of their secured claim, did not violate the absolute priority rule, was fair and equitable, satisfies 11 U.S.C. § 1129(b)(2)(A)(iii), and yielded a fair value of the Noteholders’ secured claim.”¹³⁵

In the wake of *Pacific Lumber*, the community of secured lenders was somewhat anxious and upset, and a modicum of negative commentary followed.¹³⁶ But the general feeling was that it was but an aberration; there are always odd and inexplicable outlier decisions percolating about from time to time, and surely good sense and the right and true (i.e., credit bidding *über alles*) would return and prevail, and *Pacific Lumber* would be relegated to the dustbin of misguided decisions. But when the Third Circuit followed suit six months later in the case of *In re Philadelphia Newspapers LLC*,¹³⁷ relying squarely on the Fifth Circuit to hold also that credit bidding could be dispensed with in a sale as long as the secured creditor received the “indubitable equivalent” of its secured claim under subsection (iii),¹³⁸ the angst and anger reached a fever pitch. A flurry of outraged broadside attacks on and condemnations of those decisions followed in short order.¹³⁹ Judge Ambro filed a lengthy dissent,¹⁴⁰ relying substantially on an earlier article published by Professor Brubaker.¹⁴¹

¹³² *Pacific Lumber*, 584 F.3d at 247-49.

¹³³ *Bank of America Nat’l Trust and Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 471-72 (1999). (Holding that a cram down plan in a single asset real estate case that gave the debtors the *exclusive* right to bid “new value” for the equity in the debtor violated the absolute priority rule, on the ground that the exclusive right itself constituted “property” that could not be given to a lower ranking class when a senior class of unsecured creditors dissented and was not paid in full. Central to the holding in that case was the Court’s view that *market* valuations were superior to *judicial* valuations.)

¹³⁴ *Pacific Lumber*, 584 F.3d at 247.

¹³⁵ *Id.* at 249.

¹³⁶ *See, e.g.*, Brubaker, *supra* note 10.

¹³⁷ *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010).

¹³⁸ *Id.* at 318-19.

¹³⁹ *See* Bookner, *supra* note 15; Brubaker, *supra* note 10; Brad B. Erens & David A. Hall, *Secured Lender Rights in 363 Sales and Related Issues of Lender Consent*, 18 AM. BANKR. INST. L. REV. 535 (2010); William P. Weintraub, Gregory W. Fox & Kizzy L. Jarashow, *Third Circuit Bids Credit Bidding Adieu*, 19 J. BANKR. L. & PRAC. 3 Art. 4 (2010).

¹⁴⁰ *Philadelphia Newspapers*, 599 F.3d at 319-38. (Ambro, J., dissenting).

¹⁴¹ Brubaker, *supra* note 10.

Unlike *Pacific Lumber*, the facts in *Philadelphia Newspapers* involved a more typical debtor-proposed plan, as well as an actual auction rather than a direct private sale. The chapter 11 filings by the affiliated debtors came after negotiations broke down with the debtors' consortium of lenders ("Lenders"), who had financed the purchase of the debtors in 2006 by Brian Tierney, and who held first liens in substantially all of the debtors' real and personal property.¹⁴² The heart of the plan was to be an auction of substantially all of the debtors' assets, being principally two print newspapers (the *Philadelphia Inquirer* and the *Philadelphia Daily News*) and the online publication philly.com. In addition, the Lenders were to receive the newspapers' headquarters, subject only to a short-term lease. The critical fact about the bidding procedures proposed by the debtors was that they required all bids to be *in cash*, thus negating any right of the Lenders to submit a credit bid.¹⁴³ The debtors had signed an asset purchase agreement with a stalking horse bidder, which would generate about \$37 million in cash for the Lenders. Any cash generated by a higher bid at the public auction above that of the stalking horse bid was to go directly to the Lenders.¹⁴⁴ The debtors argued that if the court barred a credit bid it would stimulate more active bidding at the auction.¹⁴⁵

At a hearing held just two days after the Fifth Circuit handed down its opinion in *Pacific Lumber*, the bankruptcy court considered the proposed bidding procedures. Bankruptcy Judge Raslavich denied the debtors' proposal, concluding that in a sale as contemplated, the plan had to comply with subsection (ii) of § 1129(b)(2)(A), which preserves the Lenders' right to credit bid, and could not be confirmed as providing an "indubitable equivalent" under subsection (iii).¹⁴⁶ On appeal, District Judge Robreno reversed in a lengthy and careful opinion, agreeing with the Fifth Circuit that the plain meaning of § 1129(b)(2)(A), with its use of the disjunctive "or" connecting the three subsections, was that a cram down plan could be confirmed if any one of the three subsections was satisfied; more precisely, that even when a sale is contemplated, the third option – the "indubitable equivalent" prong of subsection (iii) – provides an available alternative road to confirmation. Since the indubitable equivalent prong itself does not include a credit bidding requirement, no such requirement should be read in.¹⁴⁷

¹⁴² The facts are found in *Philadelphia Newspapers*, 599 F.3d at 301-02, and also in the excellent district court opinion issued by the Hon. Eduardo Robreno. See 418 B.R. 548 (E.D. Pa. 2009). I had the privilege of serving with Judge Robreno on the Advisory Committee for the Federal Rules of Bankruptcy Procedure in the 1990s.

¹⁴³ The exact terms of the bidding procedures at issue in the case can be found in the District Court opinion. See *In re Philadelphia Newspapers, LLC*, 418 B.R. at 554-55.

¹⁴⁴ *Philadelphia Newspapers*, 599 F.3d at 301-02.

¹⁴⁵ *In re Philadelphia Newspapers, LLC*, 418 B.R. 548, 555 (E.D. Pa. 2009).

¹⁴⁶ *In re Philadelphia Newspapers, LLC*, 2009 WL 3242292 (Bankr. E.D. Pa. 2009).

¹⁴⁷ *Philadelphia Newspapers, LLC*, 418 B.R. at 562-63, 567. Thus, Judge Robreno concluded that the debtors' no-credit-bid auction procedures should not have been rejected by the bankruptcy court as a matter of law, because "the unadorned statutory language of section 1129(b) ... standing alone does not provide a right to credit bid." *Id.* at 574. The District Court emphasized that "[t]he Senior Lenders retain the right to argue at confirmation, if appropriate, that the restriction on credit bidding failed to generate fair market value at the Auction, thereby preventing them from receiving the indubitable equivalent of their claim." *Id.* at 574-75.

On appeal, a split panel of the Third Circuit affirmed the District Court, casting its lot with the Fifth Circuit in the “*or* has a plain meaning” interpretive camp.¹⁴⁸ Judge Smith concurred in Judge Fisher’s opinion, with his only point of reservation being that he saw no need to even discuss the legislative history, given the clarity of the statutory text.¹⁴⁹

As noted, Judge Ambro dissented, and would have required compliance with subsection (ii) and its credit bid privilege since a sale was contemplated.¹⁵⁰ Ambro argued that the meaning of the “*or*” was not as “plain” as the majority thought. Instead, a plausible alternative reading is that (as I argued in Part I) the course of action contemplated by the plan dictates the subsection utilized: in a retention case, subsection (i) applies; in a sale, (ii) – *alone* – governs; and for everything else, (iii)’s “indubitable equivalent” test can be invoked – and, critically, the indubitable equivalent option thus cannot be applied to a sale.¹⁵¹ Judge Ambro derived this conclusion by looking at the statute as a whole, including in that analysis consideration of the § 1111(b) election, § 363(k)’s credit bid right, and the canon of interpretation that the specific (the sale provision of subsection (ii) of 1129(b)(2)(A)) controls the general (the indubitable equivalent catchall of (iii)), and also carefully weighed both the legislative history and the policy impact on the settled expectations of lenders and borrowers.¹⁵²

The majority, though, was undeterred, and found the connecting “*or*” to be plain and thus dispositive: “Because § 1129(b) unambiguously permits a court to confirm a reorganization plan so long as secured lenders are provided the “indubitable equivalent” of their secured interest, we will affirm the District Court.”¹⁵³ Given the use of the disjunctive connector, any of the three options in § 1129(b) – including, of course, the “indubitable equivalent” catch all – is an available alternative, the court concluded.¹⁵⁴ Furthermore, such a reading is not contrary to, but instead furthers, the Code’s overall goals in chapter 11 of “strik[ing] a balance between two principal interests: facilitating the reorganization and rehabilitation of the debtor as an economically viable entity, and protecting creditors’ interests by maximizing the value of the bankruptcy estate.”¹⁵⁵ The Third Circuit followed the lead of the Fifth Circuit in *Pacific Lumber* in “focus[ing] on fairness to the creditors over the structure of the cramdown”¹⁵⁶; in short, taking the Code’s disjunctive usage literally offers a more flexible set of options in giving the Lenders a “fair return” while still allowing the debtors to employ a form of reorganization that might redound to the benefit of constituencies other than just the secured creditors. Note that the

¹⁴⁸ *Philadelphia Newspapers*, 599 F.3d at 318.

¹⁴⁹ *Id.* (Smith, J, concurring)

¹⁵⁰ *Id.* at 319 (Ambro, J, dissenting).

¹⁵¹ *Id.* at 324-27. Judge Ambro relied heavily on Brubaker’s analysis. See *Id.* 599 F.3d at 325; see Brubaker, *supra* note 10.

¹⁵² *Philadelphia Newspapers*, 599 F.3d at 328-36 (Ambro, J., dissenting).

¹⁵³ *Id.* at 304 (majority).

¹⁵⁴ *Id.* at 305-06.

¹⁵⁵ *Id.* at 303.

¹⁵⁶ *Id.* at 309.

parties opposing the Lenders were (1) the debtors and (2) the unsecured creditors committee. Bottom line, the Third Circuit felt that “[w]e have no statutory basis for concluding that such flexibility, consistent with both the language and the purpose of the Code, should be curtailed.”¹⁵⁷ Thus, the court held that “we agree with the District Court and the Fifth Circuit that § 1129(b)(2)(A) is unambiguous and a plain reading of its provisions permits the Debtors to proceed under subsection (iii) without allowing the Lenders to credit bid.”¹⁵⁸

The negative reaction to *Philadelphia Newspapers* was swift, fervent, and impassioned.¹⁵⁹ The decision from *Pacific Lumber* that overturned the approximate 30-year history on § 1129(b)(2)(A) could no longer be considered a fluke; *Philadelphia Newspapers* turned the Fifth Circuit’s holding into a disturbing trend. The two holdings have been criticized on numerous grounds, ranging from a misunderstanding of the statutory structure, to a disregard of the legislative history, and finally to the policy concern that it is unfair to secured creditors, and will systematically undercompensate them.

The rulings sent shock waves through the lending community, and raised concerns about the impact on the DIP financing market.¹⁶⁰ With credit bidding possibly off the table, secured lenders would now have to cash bid, an option allegedly not possible for some lenders.¹⁶¹ Ultimately, the alarm was raised that the exposure to no-credit-bid cram down losses could raise

¹⁵⁷ *Id.* at 310.

¹⁵⁸ *Id.* at 318.

¹⁵⁹ See, e.g., Bookner, *supra* note 15; Alexander Brougham, *Seventh Circuit Paves the Way for the Supreme Court to Decide Credit Bidding Issue*, 30-JAN AM. BANKR. INST. J. 30 (2012); Vincent S. J. Buccola & Ashley C. Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 GEO. MASON L. REV. 99, 101-02 (2010); Erik W. Chalut & Blair R. Zanzig, *River Road: The Right Road for Selling a Secured Lender’s Collateral Under a Chapter 11 Plan of Reorganization*, 129 BANKING L.J. 173, 181 (2012); Hollace T. Cohen, *Is the Philadelphia Newspapers, LLC Decision the Death Knell to Credit Bidding in a Sale Under a Plan?*, 20 J. BANKR. L. & PRAC 1 Art. 1 (2011); Alan N. Resnick, *Denying Secured Creditors the Right to Credit Bid in Chapter 11 Cases and the Risk of Undervaluation*, 63 HASTINGS L.J. 323, 354 (2012).

¹⁶⁰ See Brougham, *supra* note 159; Ilana Volkov & Ryan Jareck, *River Road Hotel Partners and the Secured Creditor’s Right to Credit Bid*, 8 No. 9 WESTLAW J. BANKR. 1, 4 (2011).

¹⁶¹ Michael Goldstein, Matthew Gensburg & Whitney Baron, *Seventh Circuit Holds that Free and Clear Sale Plan Cannot Be Confirmed Without Preserving Secured Creditor Bidding Rights: Ruling Creates Circuit Split*, J. OF BANKR. L. 2011.11-10. See also Resnick, *supra* note 159, at 355 (lenders may not have sufficient liquidity to make cash bids). Secured lenders that act as a syndicate under a credit facility were claimed to be at particular risk, because not all syndicate members may even want to bid cash for the collateral, let alone will they all share the desire to have the collateral returned to them, further enhancing the probability that cash bidding will not work in this context. See Erens & Hall, *supra* note 139. As a response, many recent credit agreements specifically lay out the right to credit bid, seeking to defend the lenders against the harsh holdings from the Fifth and Third Circuits. Ben Logan, Gerald C. Bender & Jennifer Taylor, *Seventh Circuit Takes the (River) Road Less Traveled, Creating a Circuit Split on the Issue of the Right to Credit Bid in a Sale Pursuant to a Chapter 11 Plan*, J. OF BANKR. L. 2011.12-1. Additionally, secured lenders are trying to extract concessions in DIP financing agreements, which would allow them to credit bid in all circumstances where their collateral is to be sold, effectively turning DIP orders into sub rosa plans. See Weintraub, Fox & Jarashow, *supra* note 139.

the cost of financing for businesses.¹⁶² Would secured creditors once again have to go up to bat for the same rights already fought for and won during the 1978 bankruptcy legislation?

One might debate, though, whether the Chicken Little outcry and predictions that the (secured credit) world as we know it would soon end were necessarily justified. What actually happened in the *Philadelphia Newspapers* case, once the lenders were denied the right to credit bid? Were they gouged, flummoxed, mistreated, and crammed down in an egregious undervalued auction? Actually, no. As the petitioners note in their brief to the Supreme Court in the *River Road (RadLAX)* case, discussed below, “The auction in *Philadelphia Newspapers* went forward and produced spirited cash bidding with the secured lenders submitting the winning bid totaling approximately \$105 million in cash, nearly triple the amount of the initial cash bid (\$37 million) offered in connection with the asset purchase agreement.”¹⁶³

The frenzied anxiety (justified or not) that secured lenders suffered in the wake of first *Pacific Lumber* and then even more after *Philadelphia Newspapers* was assuaged to some degree in the summer of 2011 when the Seventh Circuit in *In re River Road Hotel Partners LLC*¹⁶⁴ parted company with its sister circuits and instead upheld the secured creditors’ right to credit bid in a sale plan, adopting, as had the bankruptcy court, the substance of Judge Ambro’s dissent in *Philadelphia Newspapers*.¹⁶⁵ The die has been cast and the battle lines drawn, since the Supreme Court has granted certiorari in *River Road*, in a case styled as *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*.¹⁶⁶

The *River Road* and *RadLAX* cases arose on similar facts. In each, the structure of the plan was much more like that of *Philadelphia Newspapers* than *Pacific Lumber*, with an actual auction proposed rather than a judicial valuation.¹⁶⁷ *River Road* involved a dispute when the debtor was unable to obtain additional financing from senior lenders who had loaned the debtors \$155 million to build the InterContinental Hotel at Chicago O’Hare Airport. In *RadLAX* the debtors purchased another hotel, the Radisson (“Rad”) at the Los Angeles airport (“LAX”), and borrowed \$142 million from senior lenders to both purchase the hotel and renovate it and build a parking deck. In each case, difficulties arose when the debtors could not obtain additional financing,¹⁶⁸ and the debtors then filed chapter 11. The debtors submitted plans for confirmation that called for the sale at auction of substantially all assets. In conjunction therewith the debtors sought to obtain approval for bidding procedures that would govern the proposed auction sales.

¹⁶² Roberto Ramirez, *Secured Creditors Beware –The Erosion of the Right to Credit Bid in Bankruptcy Sales*, 54-DEC RES GESTAE 26, 28 (2010).

¹⁶³ Brief for Petitioner at * 48-50, *Radlax Gateway Hotel, LLC v. Amalgamated Bank*, 2012 WL 273129 (No. 11-166) (citing Yitzhak Greenberg, *Credit Bidding After Philadelphia Newspapers: The Fat Lady Has Not Sung*, 2011 No. 7 NORTON BANKR. L. ADVISER 2 (July 2011)).

¹⁶⁴ *River Road Hotel Partners, LLC v. Amalgamated Bank*, 651 F.3d 642 (7th Cir 2011).

¹⁶⁵ *Id.* at 648-49.

¹⁶⁶ *Radlax Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 845 (2011).

¹⁶⁷ *River Road*, 651 F.3d at 649, n.4.

¹⁶⁸ *Id.* at 643-44.

Those procedures contemplated that the initial bid would be supplied by a stalking horse bidder (for \$42 million in *River Road* and \$47.5 million in *RadLAX*), and that the lenders would not be allowed to submit a credit bid.¹⁶⁹ Apparently one reason for not allowing a credit bid was to encourage more bidding by third parties, with the worry being that allowing a credit bid by the lenders would chill other bids.¹⁷⁰

In each case the lenders objected to the proposed bid procedures on the ground that the property could not be sold free and clear under a cram down plan that did not allow the lenders to make a credit bid, as contemplated by subsection (ii) of § 1129(b)(2)(A). The debtors countered that, in keeping with *Pacific Lumber* and *Philadelphia Newspapers*, cram down was allowed under the alternative third option of subsection (iii), which did not require credit bidding, and that the auction proposed would give the lenders the “indubitable equivalent” of their (grossly underwater) secured claims.¹⁷¹

This time, though, the debtors’ proposals were rejected, both by the Judge Black on the bankruptcy court¹⁷² and then by the Seventh Circuit on direct appeal.¹⁷³ Judge Black, who relied almost entirely on Judge Ambro’s dissent to find that subsection (ii) of § 1129(b)(2)(A) must be applied in a sale plan, further rejected the debtors’ fall-back arguments that even if cram down had to proceed under subsection (ii), nevertheless “cause” existed to deny credit bidding, finding no concrete evidence of the lenders’ bad faith or that allowing credit bidding would chill third party bids.

On the debtors’ direct appeal to the Seventh Circuit, the debtors of course invoked the recent favorable precedents of *Pacific Lumber* and *Philadelphia Newspapers*, and played the “plain meaning” hand.¹⁷⁴ The Seventh Circuit, however, did not bite. Presented with the opposing choices of the Fifth and Third Circuit opinions on the one hand, and Judge Ambro’s *Philadelphia Newspapers* dissent on the other, the Seventh Circuit panel, with Judge Cudahy writing the opinion, sided with the Ambro dissent.¹⁷⁵ The Seventh Circuit agreed with Ambro “that the statute does not have a single plain meaning,”¹⁷⁶ but it instead has “two plausible interpretations . . . : one that reads Subsection (iii) as having global applicability and one that reads it as having a much more limited scope.”¹⁷⁷ The court did not accord the critical “or” the

¹⁶⁹ *Id.* at 645.

¹⁷⁰ *In re River Road Hotel Partners, LLC*, 2010 WL 6634603, *2 (Bankr. N.D. Ill. 2010). The debtors also argued that the lenders had caused the debtors to fail and thus should not be allowed to credit bid.

¹⁷¹ *Id.*

¹⁷² *River Road*, 2010 WL 6634603.

¹⁷³ *River Road*, 651 F.3d at 651.

¹⁷⁴ Reply Brief for the Debtors-Appellants at 17, *River Road Hotel Partners, LLC v. Amalgamated Bank*, 2011 WL 1837512 (No. 10-3597, 10-3598).

¹⁷⁵ *River Road*, 651 F.3d at 649. (“[L]ike the bankruptcy court, we find the statutory analysis articulated by Judge Ambro in his *Philadelphia Newspapers* dissent to be compelling.”)

¹⁷⁶ *Id.* at 650.

¹⁷⁷ *Id.* at 649-50.

same conclusive talismanic status it had enjoyed in the Fifth and Third Circuits.¹⁷⁸ Thus, it was necessary to look beyond the text to discern which of the possible interpretations was correct.

The *River Road* court did not concede that a non-credit bid sale could necessarily satisfy the “indubitable equivalent” requirement of subsection (iii) itself, *even if* that subsection could potentially be applied to a sale case.¹⁷⁹ For an undersecured claim, such as was present in the case before the court (and virtually all other cases where the sale gambit under subsection (iii) is tried), “a reorganization plan will give the creditor the indubitable equivalent of its claim if the plan gives the creditor something worth the asset’s current market value.”¹⁸⁰ The debtors urged that the lenders by definition would receive the market value of their collateral, since that collateral was to be sold at auction, with the lenders to receive the sale proceeds. The *River Road* court, though, found the debtors’ argument “flawed,” because of “a substantial risk that assets sold in bankruptcy auctions will be undervalued,”¹⁸¹ a risk that can be allayed only by allowing the undersecured lender to credit bid up to the full amount of its claim. That way, the court reasoned, “[i]f a secured lender feels that the bids that have been submitted in an auction do not accurately reflect the true value of the asset and that a sale at the highest bid price would leave them undercompensated, then they may use their credit to trump the existing bids and take possession of the asset.”¹⁸² The upshot is that “the Code promises lenders that their liens will not be extinguished for less than face value without their consent.”¹⁸³ The debtors’ proposed auctions, the Seventh Circuit concluded, thus “lack a crucial check against undervaluation” and accordingly create “an increased risk that the winning bids in these auctions would not provide the Lenders with the current market value of the encumbered assets.”¹⁸⁴ If that is true, then a non-credit bid sale would *not* provide the lenders with the “indubitable equivalent” of their secured claims, and could not be confirmed even under subsection (iii).

Before moving on to the final part of the *River Road* opinion, it is worth pausing for a moment to quibble with the court’s statement about the “Code’s promise” to lenders “that their liens will not be extinguished for less than face value without their consent.” In fact, the Code makes no such promise. Indeed, in the immediately preceding and companion subsection, subsection (i) to § 1129(b)(2)(A), undersecured lenders can have their liens extinguished for less than face value, without their consent, at a judicially appraised price, when the debtor proposes to retain the collateral. It is no answer, or at best a partial and misleading answer, to say that the lender can obviate that result by making the § 1111(b) election, which entitles the lender to *total* payments equal to the “face value” of its claim, because even if the lender makes the election, the *present value* of payments to made to extinguish its claim need only equal the judicially

¹⁷⁸ *Id.* at 649 n. 5.

¹⁷⁹ *Id.* at 650.

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at 651 & n.6 (listing five reasons why bankruptcy auctions may not realize full value).

¹⁸² *Id.* at 650.

¹⁸³ *Id.*

¹⁸⁴ *Id.* at 651.

appraised value.¹⁸⁵ Nor is the “promise” even made, in an absolute sense, in sales cases themselves. The Code waffles on any such “promise” by allowing a bankruptcy court to deny a secured creditor the right to credit bid even in a sale under § 363 on a showing of “cause” under § 363(k).

Having decided that there is more than one plausible interpretation of § 1129(b)(2)(A), and turning to the task of ascertaining which of those interpretations was best, the Seventh Circuit (having pretty obviously tipped its hand with its dicta about the risk of undervaluation in non-credit bid auctions) had little difficulty in concluding that the subsection (ii) had to be used in sales cases, and that subsection (iii) and its “indubitable equivalent” test was off the table. First, the court thought that allowing debtors to invoke subsection (iii) in a sale case would render subsection (ii) superfluous,¹⁸⁶ and we all know that that is a very bad thing in interpreting statutes. The reasoning was that if a debtor can propose a sale at auction either (1) without allowing the lender to credit bid, under subsection (iii), or (2) allowing the lender to credit bid, under subsection (ii), why on earth would it ever pick the latter, which only helps the lender, at the expense of everyone else? Second, and relatedly, the *River Road* court gave credence to the canon favoring a specific section (here, subsection (ii)) over a more general section (subsection (iii)).¹⁸⁷ Finally, the court thought that the other Code sections dealing with and protecting secured creditors, most importantly § 363(k) and § 1111(b), militated in favor of the lenders.¹⁸⁸ The *River Road* court thus held “that the Code requires that cramdown plans that contemplate selling encumbered assets free and clear of liens at an auction satisfy the requirements set forth in Subsection (ii) of the statute.”¹⁸⁹

The Supreme Court now will decide the question “*Whether a debtor may pursue a chapter 11 plan that proposes to sell assets free of liens without allowing the secured creditor to credit bid, but instead providing it with the indubitable equivalent of its claim under § 1129(b)(2)(A)(iii).*”¹⁹⁰ It is safe to predict that there will be a flurry of amicus briefs, as the secured creditor community cares deeply about the outcome of this case. As I discussed in Part I, I believe that the original understanding of what Congress intended to do in enacting the Code in 1978 is as Judge Ambro argued in his influential *Philadelphia Newspapers* dissent and as the Seventh Circuit held in *River Road/RadLAX*, namely, that a sale plan can only be crammed down under subsection (ii) of § 1129(b)(2)(A), rather than under subsection (iii)’s indubitable equivalent catch all.¹⁹¹ That is, if one could indulge in time travel,¹⁹² and go back and ask the

¹⁸⁵ A creditor who makes an election under § 1111(b) is secured to the full extent the claim is allowed; not to the extent their claim is allowed under § 506(a). *See* 124 Cong. Rec. H11,089 (daily ed. Sept. 28, 1978) (statement of Hon. Don Edwards).

¹⁸⁶ *River Road*, 651 F.3d at 652.

¹⁸⁷ *Id.* at 652 n.7.

¹⁸⁸ *Id.* at 653.

¹⁸⁹ *Id.*

¹⁹⁰ 11 U.S.C. § 1129(b)(2)(A)(iii) (2010).

¹⁹¹ *Philadelphia Newspapers*, 599 F.3d 298, 319 (3d Cir. 2010) (Ambro, J., dissenting).

principal drafters of the Code in the fall of 1978 the question posed to the Court in *RadLAX*, I am quite confident that they would not even hesitate in saying “no, of course not.” But the rub, to borrow again from the Dour Dane, is that it is 2011, not 1978, and the world of secured finance is not the world President Jimmy Carter knew and loved when he signed the Bankruptcy Reform Act into law on November 6, 1978. In the next Part, I explore how that world has changed – in the secured creditors’ favor – and how the 1978 Bankruptcy Code may now be obsolete in this regard.

III. THE RISE OF SECURED CREDITOR DOMINANCE AND THE CODE’S OBSOLESCENCE

When the Bankruptcy Code became law in 1978, secured creditors faced a tenuous and uncertain struggle to maintain even a semblance of control over the course of the debtor’s restructuring in general and the fate of their collateral in particular. In large part this stemmed from the nature of corporate financing. When the Code was enacted, *unsecured* debt figured prominently in the balance sheet of large firms, while *secured* debt was used less extensively.¹⁹³ Importantly, debtor firms often entered a bankruptcy reorganization with *unencumbered* assets, which they could use to obtain new financing in the reorganization case or to help fund a plan. Having that flexibility made debtors much less dependent on their pre-bankruptcy secured lenders and reduced the leverage those lenders had.

The distribution of power in chapter 11 as enacted and as exercised reflected and indeed reinforced the shape of the then-existing financial markets. Indeed, a cogent case could be made that the need for, utility of, and shape of a corporate reorganization law at that time stemmed in part from the lack of a coherent and predictable allocation of control rights over the fate of a financially distressed firm in the marketplace.¹⁹⁴ In that milieu, how did the 1978 Code assign power?

First, debtors and their managers enjoyed a significant amount of control over the course of a chapter 11 case.¹⁹⁵ Second, unsecured creditors also had considerable leverage, reflective of

¹⁹² Which would be exciting and interesting, although undoubtedly not quite as interesting as in Stephen King’s book *11/22/63: A NOVEL* (2011), where the time traveler tries to stop Lee Harvey Oswald from assassinating President Kennedy.

¹⁹³ Skeel, *supra* note 5, *Creditor’s Ball*, 152 U. PA. L. REV. at 925.

¹⁹⁴ Baird & Rasmussen, *supra* note 5, *End of Bankruptcy*, 55 STAN. L. REV. at 778-85.

¹⁹⁵ Indeed, the extent of this control is largely what inspired much of the early grumbling about the weakness of chapter 11. See Lynn M. Lopucki, *The Debtor in Full Control – Systems Failure Under Chapter 11 of the Bankruptcy Code*, 57 AM. BANKR. L.J. 247 (1983). Observers saw debtor-managers able to use bankruptcy as a tool to extract concessions from creditors, and it was argued that bankruptcy was more endogenous than generally believed. See Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992). Of course, this thesis did not go unchallenged, *see, e.g.*, Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992); Charles J. Tabb, *The Future of Chapter 11*, 44 S.C. L. REV. 791, 812-15 (1993); Elizabeth Warren, *The Untenable Case for the Repeal of Chapter 11*, 102 YALE L.J. 437 (1992), but the truth of debtor control was not seriously disputed -- only whether that was a good thing.

their significance on the balance sheet, through the creation and empowerment of official committees.¹⁹⁶ Secured creditors, by comparison, often played only a subsidiary and reactive role in the case. Debtors presumptively were entitled to continue as the debtor in possession,¹⁹⁷ and were given the exclusive right to propose a plan of reorganization for 120 days.¹⁹⁸ Courts were loathe to replace debtor management with an independent trustee, and routinely granted extensions of exclusivity.¹⁹⁹ The upshot was that debtor firms could linger in chapter 11, sometimes for years, enjoying an interest-free sabbatical from debt payments while they waited out their pre-bankruptcy secured creditors and pressured them to cave in to the debtor's restructuring demands.²⁰⁰ Violations of absolute priority were allowed,²⁰¹ and in many cases became the rule rather than the exception.²⁰² Secured creditors could not repossess or foreclose on their collateral due to the imposition of the stay,²⁰³ had to return collateral even if already repossessed,²⁰⁴ and, significantly, did not get paid for the delay they suffered unless they were oversecured.²⁰⁵ A pre-bankruptcy secured lender even faced the ignominious prospect of being subordinated from the senior to the junior position in the financing of the reorganization.²⁰⁶ Even if a pre-bankruptcy lender was not subordinated, the existence of unencumbered property, as noted above, meant that the debtor could look elsewhere for DIP financing, in a more competitive environment. In short, debtors often called the shots, not pre-bankruptcy lenders. The main constraint on a debtor's freedom of action often was the need to propose a plan that got the unsecured creditors on board so that the old managers could retain control through the unsecureds' waiver of absolute priority.

In that world, distortions of efficiency and fairness often followed from the disconnect between control rights – enjoyed inordinately by entrenched management – and the economic

¹⁹⁶ See 11 U.S.C. § 1102 (2005); 11 U.S.C. § 1103 (1984).

¹⁹⁷ See 11 U.S.C. § 1101 (1978); 11 U.S.C. § 1104 (2010).

¹⁹⁸ 11 U.S.C. § 1121(b) (1978) (later amendments in 1984, 1986, 1994, and 2005).

¹⁹⁹ See generally Kenneth N. Klee & Frank A. Merola, *Ignoring Congressional Intent: Eight Years of Judicial Legislation*, 62 AM. BANKR. L.J. 1 (1988).

²⁰⁰ See Tabb, *supra* note 196, at 837-40; Skeel, *supra* note 5, *Financing*, 25 CARDOZO at 1916.

²⁰¹ 11 U.S.C. § 1129(b) (2010).

²⁰² See Lynn M. LoPucki, *COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING BANKRUPTCY COURTS* (University of Michigan Press 2005) (summarizing 1990s studies); Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WISC. L. REV. 11 (discussing courts' practice of allowing deviations from the absolute priority rule, and the impact on forum shopping); Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597 (1993) (reporting the percentage of shares retained by equity in violation of the absolute priority rule); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 3, 747, n. 247 (1993) (management sometimes holds out for distributions in equity under a reorganization in violation of the absolute priority rule).

²⁰³ 11 U.S.C. § 363(a) (2010).

²⁰⁴ See 11 U.S.C. § 542(a) (1994); *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 211-12 (1983).

²⁰⁵ See 11 U.S.C. § 506(b) (2005); *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assoc., Ltd.*, U.S. 365, 375 (1988).

²⁰⁶ 11 U.S.C. § 364(d) (1994).

interests of financial stakeholders, especially, for the purposes of this article, those holding secured debt. In concept these distortions could arise in both operating cases, where debtors could impose pressure for concessions from stakeholders through uncompensated delay, having already gotten the financing they needed to effect the delay from other quarters, and in single asset cases, where a debtor could try to time a bankruptcy filing to take advantage of temporarily depressed – or simply misvalued – real estate prices (e.g., the *Pine Gate*²⁰⁷ strategy). To counter such distortions, it was an understandable and defensible counter-balance for the Bankruptcy Code to afford powerful collateral value realization protections to secured creditors already effectively dispossessed and declawed. The means of protection, as discussed in Part I, was the dual play of the § 1111(b) election (effective in collateral retention cases) and a largely immutable right to credit bid (effective in sale cases), either via § 363(k) (for sales during the case) or § 1129(b)(2)(A)(ii) (for plan sales).

That is a great story. At one time, it was true. But it is not true any more. And it is not true for a simple reason: secured creditors took back control. How? By controlling the flow of money to the debtor firm. Any firm of course needs money to operate. This is true outside of bankruptcy, and it is true in bankruptcy. No money, and the firm dies. The single most significant change that has affected bankruptcy reorganizations is that the nature of financing has shifted. Today, senior secured debt rules.²⁰⁸ This is especially true for firms that approach and enter bankruptcy, which reveal a dramatic increase in secured debt.²⁰⁹ Secured lenders now commonly hold first priority liens and mortgages on all or substantially all of the debtor's assets. Furthermore, these senior secured lenders are employing the power that flows from providing the financing to impose significant control rights over the debtor through extensive loan covenants.²¹⁰ This control is exercised prior to filing, in making the filing, and after the filing. With no unencumbered assets, and management serving at the mercy of the senior lenders, it usually is not possible to obtain DIP financing other than from the pre-bankruptcy secured lenders. Warren and Westbrook have aptly named the new phenomenon “secured party in possession;”²¹¹ Skeel calls it the “creditors’ ball.”²¹² Baird and Rasmussen demonstrate how these all-powerful secured lenders now effectively control what happens in a chapter 11 case.²¹³

Debtor management has little if any freedom of action; if they want money for the firm, or a job for themselves, then they have little choice but to do the senior secured lenders’ bidding. Or the lender may – and often does – simply replace old management with its hand-picked

²⁰⁷ *In re Pine Gate Assoc., Ltd.*, 1976 WL 359163 (Bankr. N.D.Ga.1976), aff’d, 1976 WL 359641 (N.D. Ga. 1976).

²⁰⁸ Ayotte & Morrison, supra note 5 at 512. See also Skeel, supra note 5, *Creditors’ Ball*; Baird & Rasmussen, supra note 5, *Private Debt*; Baird & Rasmussen, supra note 5, *End of Bankruptcy*.

²⁰⁹ Ayotte and Morrison find that public companies experience an eleven-fold increase in secured debt during the one to two years prior to the bankruptcy filing. Ayotte & Morrison, supra note 5, at 518.

²¹⁰ Baird & Rasmussen, supra note 5, *Private Debt*.

²¹¹ Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, 22-SEP Am. Bankr. Inst. J. 12 (2003).

²¹² Skeel, supra note 5, *Creditor’s Ball*, 152 U. PA. L. REV. at 925.

²¹³ Baird & Rasmussen, supra note 5, *Private Debt*, 154 U. PA. L. REV. 1209; Baird & Rasmussen, supra note 5.

agents. The bidding urged upon management, be it old or new, often is to quickly dispose of the assets via an auction sale.²¹⁴ Chapter 11 has become in many instances a convenient mechanism for the secured lenders to realize upon their collateral.²¹⁵ Or, as Skeel observes, lenders may use DIP financing to take control of a debtor firm in a way that would not be possible outside of bankruptcy under standard norms of corporate law.²¹⁶

In this new financial world, does the core presumption that motivated the 1978 Code rules protecting a secured party – *viz.*, of disenfranchised helplessness in need of paternalistic protection – still hold? Is credit bidding today a necessary safeguard for secured lenders? In light of the current financial reality, with the levers of control firmly in the hands of lending banks, the answer seems to be “no” – at least not presumptively, for *all* secured creditors. Do we really need to maintain potent protections for the party who already holds almost all of the power? If not, then the obvious concern arises that we have a comprehensive and complex statutory scheme that is designed to guard against a problem that often does not exist. In short, has chapter 11 become obsolete as regards the treatment of secured creditors in this context? I submit that the answer is “yes.”

Indeed, the reality is that far from being a floor safeguard for disempowered secured lenders, credit bidding often is used *by* the secured lender as a means of assuring that it will be able to foreclose or realize upon its collateral at an acceptable price, in an auction *instigated by the secured creditor*. While the secured creditor could also foreclose outside of bankruptcy, and in doing so typically would have the right to credit bid,²¹⁷ the beauty of a foreclosure sale *in* bankruptcy is that the secured creditor might be able to get a higher price for the collateral because the bankruptcy purchaser can get a thoroughly cleansed title through a free-and-clear sale.²¹⁸ Bankruptcy sales are so popular in large part because the purchaser’s title is about as clean as it possibly can get anywhere in the law. The Seventh Circuit in *RadLAX* upheld the secured creditor’s credit bidding right in part because the court believed that bankruptcy sales brought artificially *low* prices,²¹⁹ and thus secured creditors had to have the credit bid right to protect them from any risk of being stuck with just such a low sale price. In fact, though, the reality may be exactly to the contrary: bankruptcy sales often bring higher prices – a fact suggested by the immense popularity of bankruptcy sales! – *and* the sale often is initiated by the secured creditor.²²⁰ A secured creditor foreclosing on its collateral through a bankruptcy sale gets a clean title, possibly a higher price (or at least zero risk of a lower price, because of credit

²¹⁴ Greg McGlaun, *Lender Control in Chapter 11: Empirical Evidence*, working paper, University of Rochester. (Available at: <http://ssrn.com/abstract=691365>) (2007).

²¹⁵ Warren & Westbrook, *supra* note 211.

²¹⁶ Skeel, *supra* note 5, *Financing*, 25 CARDOZO at 1929-32.

²¹⁷ See, e.g. U.C.C. § 9-601 (2011). See also Ethan S. Bernstein, *All’s Fair in Love, War & Bankruptcy? Corporate Governance Implications of CEO Turnover in Financial Distress*, 11 STAN. J. L. BUS. & FIN. 298-324 (2006).

²¹⁸ 11 U.S.C. § 363 (2010).

²¹⁹ *River Road Hotel Partners, LLC v. Amalgamated Bank*, 651 F.3d 642, 653 (7th Cir. 2011).

²²⁰ Warren & Westbrook, *supra* note 211.

bidding), and a safe port in the storm from any other creditor actions against the debtor's assets because of the automatic stay. It is difficult to justify *requiring* credit bidding – as I argued in Part I the Bankruptcy Code was designed to do – when the secured creditor is essentially using the bankruptcy law, “a mechanism designed to benefit creditors generally, as their own private, low-cost tool to maximize their own collections.”²²¹

Even if the secured creditor is not the one who initiates the bankruptcy auction, how severe is the risk of undervaluation harm from a non-credit bid sale? Let us revisit the two vilified “no credit bid” circuit court cases for a moment. First, what about the saga of the *Philadelphia Newspapers* case? Recall that the senior secured lenders were denied the right to credit bid by the Third Circuit.²²² So what happened? An auction was held, and the winning bidder was: the senior secured lenders, who bid *cash* (of \$105 million), substantially topping the next highest bid.²²³ Or, what about the *Pacific Lumber*²²⁴ judicial valuation cram down? No open bidding at all was allowed in that case, much less a credit bid by the secured party; instead, the court blessed the private sale to the plan proponents and purchasers at a judicially appraised price. But the evidence was extensive that the appraised price was fair.²²⁵

Indeed, it may now be the case that the balance of power has shifted so much in favor of secured creditors that the only feasible counter for the debtor or for competing financial stakeholders in the debtor's assets is to be able to pursue a sale of the collateral in bankruptcy which the dominant secured creditor cannot effectively preempt by playing the credit bidding trump card. If a public auction is held, as in *Philadelphia Newspapers*,²²⁶ let the secured creditor bid, but make them play with real money. If a private sale is held, as in *Pacific Lumber*,²²⁷ the court should insist on rigorous valuation evidence. And if the secured creditor actually is a powerless, exposed, pawn – rather than the other way around – or if appraisals are just too uncertain in the particular circumstances, nothing would prevent the bankruptcy court from requiring credit bidding *in that case*. If the secured creditor can make a persuasive and particularized showing to the bankruptcy court why denial of the credit bid right would cause it prejudice, then the court could allow credit bidding.

In short, I argue that the time has come to reverse the presumption. Given the state of the financial markets, and the standard dominant position of secured lenders, presumptively (indeed, almost conclusively) *requiring* credit bidding is the wrong default rule. Statutory default rules

²²¹ *Id.* at 51.

²²² *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 319-20 (2010).

²²³ See e.g., Steven Church, *Philadelphia Inquirer Lenders Best Perlman in Bankruptcy Court Auction*, BLOOMBERG (Sept. 23, 2010), available at <http://www.bloomberg.com/news/2010-09-23/philadelphia-inquirer-lenders-outbid-raymond-perelman-for-newspaper-owner.html> (consulted Feb. 23, 2012).

²²⁴ *Scotia Pac. Co. v. Official Unsecured Creditors' Comm. (In re The Pac. Lumber Co.)*, 584 F.3d 229, 249 (5th Cir. 2009).

²²⁵ *Id.* at 229, 249.

²²⁶ *Philadelphia Newspapers, LLC*, 599 F.3d at 304-08 (3d Cir. 2010).

²²⁷ *Pacific Lumber*, 584 F.3d at 301.

work best and most efficiently when they reflect the superior outcome in the majority of cases, especially where, as here, the question is whether a court should leave the default rule unaltered or affirmatively act to override the default based on a particularized showing.²²⁸ Today, with the shift in financial realities, the norm is secured creditor in control, not secured creditor on the run. I thus submit that the preferred default rule is *not* to allow credit bidding, but only resort to such a safeguard if the secured creditor actually needs it in the particular case.

IV. WHAT NOW?

My conclusion in Part III was that the world of corporate finance has changed such that credit bidding is no longer a necessary or even desired *sine qua non* of bankruptcy collateral sales. That leaves me, though, with the puzzle of what to do given that I believe that Congress intended the Code to operate so as to presumptively require credit bidding. At the outset, I want to make it clear that I do not believe that the Bankruptcy Code has a “*plain meaning*” that would *require* the credit bidding privilege to be presumptively afforded to secured creditors in a cram down plan sale through the application of subsection (ii) of § 1129(b)(2)(A), to the exclusion, in all cases of the “indubitable equivalent” test of subsection (iii). Indeed, as discussed in Part II, the only “plain meaning” rulings to date have gone the other way, with the Fifth²²⁹ and Third²³⁰ Circuits holding that the plain meaning of the disjunctive “or” in § 1129(b)(2)(A) is that the plan proponent always has the option to seek cram down under the subsection (iii) indubitable equivalent test rather than under the credit bid sale option of subsection (ii). However, as I explained above, as Professor Brubaker has convincingly argued previously,²³¹ as Judge Ambro asserted in dissent in *Philadelphia Newspapers*,²³² and as the Seventh Circuit in *River Road* held,²³³ an equally if not more plausible interpretation of the disjunctive nature of § 1129(b)(2)(A) is that each subsection applies to its corollary method of dealing with the collateral, *viz.*, subsection (i) applies in retention cases, (ii) in sale cases, and (iii) for all other cases (such as, e.g., abandonment of collateral or the use of replacement liens).

So I proceed on the assumption that the statute, viewed in isolation, admits of more than one possible interpretation. I further posited (in Part I) that the *original* intent of Congress when it enacted the Code in 1978, drawing on the most reliable and traditional sources of statutory

²²⁸ Since the default issue here involves action *by a court*, as contrasted with default rules that govern contracting behavior, the set of concerns theorized by Ayres and Gertner, wherein majoritarian “would have wanted” defaults might not always be best, see Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989), would not apply.

²²⁹ *Pacific Lumber*, 584 F.3d at 245.

²³⁰ *Philadelphia Newspapers*, 599 F.3d at 304-08.

²³¹ Brubaker, *supra* note 10.

²³² *Philadelphia Newspapers*, 599 F.3d at 324-27 (Ambro, J., dissenting) (finding no plain meaning in § 1129(b)(2)(A)).

²³³ *River Road Hotel Partners, LLC v. Amalgamated Bank*, 651 F.3d 642, 650 (7th Cir. 2011) (agreeing with Judge Ambro that § 1129(b)(2)(A) lacks plain meaning).

meaning, namely the consideration of the statute as a whole, its history, and its purpose, was that a secured creditor indeed *should* be entitled in a cram down plan sale to insist on the invocation of subsection (ii) to § 1129(b)(2)(A), rather than subsection (iii). Having said that, though, the next step in my analysis (discussed in Part III) is that in light of *current* conditions, the better approach is the opposite interpretation, namely, that credit bidding under subsection (ii) need not always be required, and that in appropriate cases cram down should be allowed under subsection (iii)'s indubitable equivalent test in a sale without necessarily offering the secured creditor the credit bid option.

I recognize that a court which agreed with my assessment of point 3 (that the best current interpretation would be to allow cram down in a sale plan under the “indubitable equivalent” test of subsection (iii)) might well fudge on point 2 and conclude that Congress in fact so intended all along. Indeed, a court so inclined might well even fudge on point 1 and find that the statute has a “plain meaning” that would allow utilization of the indubitable equivalent test.

But let us assume that a court is both wise (i.e., agrees with my three points) and scrupulously honest and thus will not play either fudging game. The question then arises whether it would be appropriate for such a court, which agreed with my assessment of each of the foregoing three conclusions, to hold that credit bidding could be dispensed with and cram down allowed in a sale plan only through a non-credit-bid indubitable equivalent test. Simply put, is it acceptable for a court to disregard the probable but not “plain” original intent of Congress in light of changed circumstances? To be sure, there is scholarly support for such an approach – most notably, the “dynamic statutory interpretation” model propounded by Eskridge:

The dynamic model, however, views the evolutionary perspective as most important when the statutory text is not clear and the original legislative expectations have been overtaken by subsequent changes in society and law. In such cases, the pull of text and history will be slight, and the interpreter will find current policies and societal conditions most important. The hardest cases, obviously, are those in which a clear text or strong historical evidence or both, are inconsistent with compelling current values and policies.

...

My purpose ... is to challenge the often-stated (but less often believed) assumption that statutory interpretation is nothing but an exercise in finding answers that were fixed when the legislature originally enacted the statute. Like other texts, statutes are dynamic things: they have different meanings to different people, at different times, and in different legal and societal contexts. It is a significant departure from current doctrine to assert, as I do, that federal courts should interpret statutes in light of their current as well as historical context. Dynamic interpretation is most appropriate when the statute is old yet still the source of litigation, is generally phrased, and faces

significantly changed societal problems or legal contexts. Dynamic interpretation is least appropriate when the statute is recent and addresses the issue in a relatively determinate way.²³⁴

In Eskridge's world, I believe that a strong case can be made that courts could find the credit bidding conundrum to be an apt case for application of dynamic statutory interpretation. The statutory text is not clear (and if by some chance the text is thought to be clear, that clarity is in favor of, not opposed to, my preferred interpretation); the statute is "old" (a third of a century) in the context of the rapidly evolving world of corporate finance; and the original legislative expectations, which were predicated on the need to protect relatively toothless secured creditors, have been overtaken by subsequent developments, in which the power position of secured creditors has increased dramatically. Cutting the other way is what I believe to be strong historical evidence of the original intended meaning, supported by an arguable textual specificity in the immediate statutory text itself. On balance, though, a dynamist would be comfortable reversing the Seventh Circuit in *RadLAX*.

That holds, though, only if one accepts Eskridge's view of the permitted bounds of judicial interpretation of a statute. Such a view counters the traditional "faithful agent" theory of the role of the judiciary: "In our constitutional system, it is widely assumed that federal judges must act as Congress's faithful agents. On that assumption, if Congress legislates within constitutional boundaries, the federal judge's constitutional duty is to decode and follow its commands, particularly when they are clear."²³⁵ Even if the textual commands are not unfailingly clear, or if as literally read might be at odds with the well-understood purpose of the legislative enactment, a faithful judicial agent *at most* could align herself with a so-called "strong purposivist" view²³⁶ and interpret a statute consonant with the "purpose" divined to have been contemplated by the *enacting* Congress. Strong textualists, most notably Justices Scalia²³⁷ and Thomas,²³⁸ would recoil at even this degree of judicial activism. Either way, in my view the secured creditor would win and get to credit bid, because I think that the evidence is overwhelming that *the 1978 Congress* had an unmistakable purpose to afford significant protection to secured creditors by virtually guaranteeing them the right to credit bid when their collateral was being sold.²³⁹ My sentiments lean in favor of the "strong purposivist" school (Justice Stevens, I salute you),²⁴⁰ and if called upon to decide *RadLAX* would feel duty bound to

²³⁴ William N. Eskridge, *Dynamic Statutory Interpretation*, 135 U. PA. L. REV. 1479, 1484, 1554-55 (1987).

²³⁵ See, e.g., John F. Manning, *Textualism and the Equity of the Statute*, 101 COLUM. L. REV. 1, 5 (2001).

²³⁶ *Id.* at 3-4.

²³⁷ *Id.* at 8.

²³⁸ Justice Thomas indeed even invoked the spirit of Dr. Seuss (from the elephant in "Horton Hears a Who," who said "I meant what I said and I said what I meant. An elephant's faithful one-hundred percent!") when in a bankruptcy case he observed that "We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there." See *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992).

²³⁹ Klee, *supra* note 9.

²⁴⁰ E.g., Manning, *supra* note 235, at 3 n.4.

affirm and hold for the secured creditor, because I believe that such is both the fairest reading of the entire statutory text and also was indisputably the intention of the enacting Congress in 1978.

But I do not think that requiring presumptive credit bidding is the preferred approach *today*, in light of the shift in the nature of corporate finance and the rise in power of secured creditors. Furthermore, the economic downturn in 2008 and its fallout have led to even more weakness for debtors. Rather, my preference would be to *reverse the presumption*.

Since I have just concluded that only a radical dynamic interpreting judge would (or should) so read the current Bankruptcy Code, I believe that to change the presumptive default rule would require some modest amendments to the Bankruptcy Code. In short, I argue that Congress should set the baseline rule as *not* requiring credit bidding, but allow the court for cause to order otherwise. I also would recommend clarifying the cramdown treatment of secured creditors so that it is clear that not only is there no presumptive right to credit bid, but further that cram down at a judicially appraised price – as contemplated long ago in *Union Central*²⁴¹ and then in *Pine Gate*²⁴² – would be acceptable, even in a sale. Indeed, I am not even certain that the case still can be made for the need for the § 1111(b) election, but that is an ox to be gored in a later paper. In setting the baseline standard for cram down protection, and with apologies to the ghost of Learned Hand, I would urge that the time has come to jettison the unfortunate “indubitable equivalent” language, which has accumulated unwieldy and unhelpful baggage; in its stead, why not simply resurrect the catch-all standard from old chapter X, as initially proposed in the 1973 Commission bill, *viz.*, that the plan’s cram down treatment of secured claims must “*equitably and fairly provide for the realization by them of the value of their claims*”²⁴³

Thus, my recommended amendments to the Bankruptcy Code are as follows. I have stricken and interlined the statutory text; recommended additions are in italics, and text to be stricken is lined through.

§ 363(k). At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, *if the court for cause so orders*, such holder may offset such claim against the purchase price of such property.

²⁴¹ *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273, 278 (1940).

²⁴² *In re Pine Gate Assoc., Ltd.*, 1976 WL 359163 (Bankr. N.D.Ga.1976), *aff’d*, 1976 WL 359641 (N.D. Ga. 1976).

²⁴³ H.R. 10792, 93d Cong., § 7-307(7) (1973).

§ 1129(b)(2). For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan *equitably and fairly provides for the realization by the holders of such claims of the value of their claims, including any of the following—*

(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;

(iii) *appraisal and payment in cash of the value of such claims; or*

(iv) *any other means for the equitable and fair realization by such holders of the ~~indubitable equivalent~~ value of such claims.*

It is my hope that such an amendment would free us from the never-never land of eternal mystery that our invocation of indubitable equivalence, in conjunction with the uncertain disjunctive structure of current § 1129(b)(2)(A), has wrought. It is time to return to first principles, with the paramount first principle being that secured creditors are entitled to realize the value of their collateral – no more and no less. With secured creditors having assumed a position of dominance, the 1978 Bankruptcy Code balancing act has become obsolete. The time has come to restore the balance.