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No. 11-166

In The
Supreme Court of the United States

RADLAX GATEWAY HOTEL, LLC, et al.,

Petitioners,

v.

AMALGAMATED BANK,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF FOR BANKRUPTCY SCHOLARS AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

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INTEREST OF *AMICI CURIAE*

Amici curiae are law scholars who write and teach about bankruptcy and corporate reorganization.[1]

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Amici have a professional interest in illuminating this Court's consideration of the important and complicated questions this case presents.

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[1] The parties have consented to the filing of this brief, written evidence of which accompanies the filing. No counsel for a party authored this brief in whole or in part, and no person (other than *amici curiae* or their counsel) made a monetary contribution intended to fund the preparation or submission of this brief.

STATUTORY PROVISION IN ISSUE

11 U.S.C. § 1129(b)(2) states:

(1) Notwithstanding Section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if 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.

(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 [must] provide[ ] –

(i)

(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of

such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

* * *

STATEMENT

This case presents the question whether a bankruptcy court may confirm, over creditor objection, a plan of reorganization that proposes to sell substantially all of the debtor's assets without permitting the secured creditors to bid for the assets with credit. The short answer is that because credit bidding maximizes the value of the bankruptcy estate and ensures

that secured creditors receive the full value of their collateral, the decision below should be affirmed.[2] A debtor in bankruptcy may not auction itself while forbidding secured creditors from using the debtor's obligation as consideration for the purchase.

To see why, it is important to understand first what credit bidding is, and what it is not. In the simplest terms, a credit bid is a creditor's offer to buy assets by offsetting the debt owed to him by the amount of the bid. *See Freedom Mortgage Corp. v. Burnham Mortgage, Inc.*, 569 F.3d 667, 670 (7th Cir. 2009); *In re Phila. Newspapers, LLC*, 599 F.3d 298, 320-21 (3d Cir. 2010) (Ambro, J., dissenting). Take a simple example. Suppose that debtor D owes $100 to secured creditor C, whose security interest extends to all of debtor's assets. The object of the credit bid is one asset of D. If C values it at $60, a credit bid is C's offer to reduce D's $100 debt to $40 in exchange for the asset. The creditor essentially uses the debt as a form of currency. If he wins the auction, C comes away with the asset and a $40 secured claim.

As far as a bankruptcy estate is concerned, the results of a senior creditor's credit bid exactly replicate the results of a cash bid. Returning to the hypothetical above, imagine that creditor C, who still values the asset at $60, is prohibited from credit

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[2] *Amici* agree with Petitioners that this controversy is not moot. Hence *Amici* believe this Court's jurisdiction to decide the case is secure.

bidding. To fund his bid, C must take out a $60 loan from Bank. At auction he offers cash for the asset, and wins, paying debtor D cash from the bank loan. Now D turns around and remits the proceeds of the collateral sale to C. (As the secured creditor, C has a right to sale proceeds up to the amount of his security interest. 11 U.S.C. § 506(a).) C applies the $60 to repay Bank for the initial loan. Just as when credit bidding was allowed, the story ends with C in possession of the asset and D still owing C $40. Whether C's bid and payment are in the form of cash or credit has no effect on D or the assets of the bankruptcy estate, and hence does not alter the rights of D's general creditors or other junior claimants. *See* Vincent S. J. Buccola & Ashley C. Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 Geo. Mason L. Rev. 99, 103-04 (2010) (providing mathematical model). The logic of credit bidding is that it avoids a senseless shuffling of funds from Bank to Creditor to Debtor back to Creditor and, finally, to Bank.

But these simplified hypotheticals omit the transaction costs associated with C's bank loan – the fees and interest he must pay to obtain the loan. From the secured creditor's perspective, transaction costs are part of the price paid for the asset. Assume Bank charges C $5 in fees and interest to make the loan. If C values the asset at $60, his reservation price at auction will be only $55, $5 less than his reservation price if he is allowed to credit bid. If C's $55 bid carries the day, C gets the asset and is left with a $45 secured claim instead of the $40 claim he had when

allowed to pay with credit. To D, and therefore to the bankruptcy estate and its residual claimants, that is $5 left on the table that could have been used to satisfy other claims against the estate. Each dollar C pays in financing costs reduces by a dollar the bankruptcy estate.

A trustee is charged with maximizing the value of the bankruptcy estate. *Wabash Valley Power Ass'n, Inc. v. Rural Electrification Admin.*, 903 F.2d 445, 451 (7th Cir. 1990). Given this mandate, it is not immediately clear why the debtors in this case seek to exclude a potential bidder – or to reduce a potential bidder's reservation price – by imposing transaction costs. More bidders mean a higher expected sale price. *See* Buccola & Keller, *supra*, at 119-20. A rational seller should want to reduce transaction costs for prospective buyers, not increase them. The answer, here as in many other cases, is that the debtors have a preferred buyer in mind. It is not necessarily the buyer who will contribute the most to the estate in exchange for its assets. It is rather a buyer who has something to offer the debtors' management or other insiders. *See* Resp. Br. 12-13 (noting that a principal of the debtors, Peter Dumon, had an interest in the debtors' preferred "Stalking Horse" bidder); *see also Phila. Newspapers*, 599 F.3d at 320 (Ambro, J., dissenting).

SUMMARY OF THE ARGUMENT

The decision below should be affirmed, but on a rationale different from that adopted by the Seventh Circuit and urged by Respondent in this Court. The Seventh Circuit was right that Section 1129(b)(2) of the Bankruptcy Code guarantees a secured creditor's right to bid credit when the debtor proposes to sell substantially all of its assets – but not because Congress intended, without saying so, that subsection (b)(2)(A)(ii) apply to all sale plans. A plan satisfying any of the three clauses of subsection (b)(2)(A) may be crammed down, provided that the plan be "fair and equitable."

But there lies the rub. An auction plan that bars credit bidding is not "fair and equitable" within the meaning of the Bankruptcy Code. Credit bidding is an auction feature that can augment and cannot diminish the sale price of a debtor's assets. Credit bidding increases the pool of knowledgeable buyers and decreases transaction costs associated with submitting a bid, both of which tend to drive up the assets' sale price and therefore creditor recoveries. Under the longstanding principle of *Butner v. United States*, 440 U.S. 48 (1979), moreover, a claimant's state-law property rights are preserved throughout reorganization absent a bankruptcy-specific justification for their extinction. Because credit bidding (1) maximizes the value of the debtor's estate, which is an unmitigated good for the junior claimants, and (2) ensures that a secured creditor receives the value of his collateral, as he would in a sale under, for example, Article 9 of the

Uniform Commercial Code, a sale plan that eschews credit bidding is not fair and equitable.

ARGUMENT

In the typical bankruptcy, a plan of reorganization can be confirmed only with the consent of every impaired class of creditor. 11 U.S.C. § 1129(a)(8). The rule covers cases such as this where the debtor "reorganizes" by selling itself as a going concern to the highest bidder. To discourage unreasonable holdouts, however, the Bankruptcy Code allows the bankruptcy judge to confirm a plan over creditor objection – to "cram down" the plan, in the parlance of bankruptcy practice – if the plan meets specified conditions. 11 U.S.C. § 1129(b); *see Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 441 (1999).

Under Section 1129(b)(1), the court may cram down "if 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." The next subsection, (b)(2), says that "the condition that a plan be fair and equitable with respect to a class *includes* the following requirements" (emphasis added), and goes on to list three, each of which can be fulfilled in multiple ways. 11 U.S.C. § 1129(b)(2).

The parties disagree about the meaning of one of subsection (b)(2)'s requirements, namely subsection

(b)(2)(A). Petitioners argue that because the word "or" disjoins the subsection's three clauses, a plan is confirmable if it has any of the three enumerated features. Respondent, on the other hand, thinks it implied in the structure of the statute that the condition following romanette (ii) is mandatory in every plan proposing to sell assets free and clear of liens.

Petitioners are right about the meaning of subsection (b)(2)(A). A plan satisfies that subsection's "requirement," as the Code terms it, if the plan has any one of the three enumerated features. But Petitioners are wrong to suggest that every plan meeting the minima established by subsection (b)(2)(A) should be crammed down. *See* Pet. Br. 5, 9-11. The requirements of subsection (b)(2)(A) are necessary but insufficient. A plan that, for example, permitted the debtor to extract a pound of the winning bidder's flesh would not be "fair and equitable," 11 U.S.C. § 1129(b)(1), even if it met one of the requirements of subsection (b)(2)(A). The same goes for an auction plan that proposes to sell substantially all of the debtor's assets while barring credit bids.

I. Section 1129(b)(2)(A)(ii) Does Not by Terms Require that an Auction Plan Permit Credit Bidding

Chapter 11 plans of reorganization vary depending on the debtor's agenda. Some are designed to promote a *bona fide* reorganization, where the debtor uses statutory avenues to escape onerous contracts,

refine its operations while staving off creditors who might otherwise levy on the firm's assets, and emerge from bankruptcy with a financially viable balance sheet. Other plans, such as the plan at issue in this case, contemplate a sale of the debtor as a going concern. The sale generates a pool of cash used by the estate to pay allowed claims according to the priorities the Bankruptcy Code establishes.

The Code does not categorize types of plans, however. It speaks simply of "a plan" or "the plan." *E.g.*, 11 U.S.C. § 1129(a). More specifically, the requirements of cramdown do not vary by type of plan. Section 1129 says only that "the plan" is confirmable if "it 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." 11 U.S.C. § 1129(b)(2). Subsection (b)(2)(A)(ii) allows "the plan" to fulfill one of the prerequisites to cramdown if it provides for an asset sale at which credit bidding is permitted. It does not say that asset sales at which credit bidding is verboten *cannot* otherwise fulfill the requirements.

Following the opinion of the court of appeals (as well as Judge Ambro's dissent in *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 321-38 (3d Cir. 2010)), Respondent argues that subsection (b)(2)(A)(ii) of Section 1129 is more "specific" than subsection (b)(2)(A)(iii) – that, in other words, subsection (b)(2)(A)(ii) would be obsolete under the debtors' reading. Resp. Br. 27-29. In order to give each statutory phrase meaning, Respondent argues, the Court should construe

(b)(2)(A)(iii) not to apply when the plan of reorganization proposes to sell assets free and clear of liens. *See ibid.*

The argument is misguided. The canon favoring preservation of specific provisions matters only when one statutory provision is a subset of another. *Nat'l Cable & Telecomms. Ass'n v. Gulf Power Co.*, 534 U.S. 327, 335-36 (2002) ("The specific controls but only within its self-described scope."); *Katz v. Gerardi*, 552 F.3d 558, 561-62 (7th Cir. 2009). Each of the two provisions at issue here covers cases not covered by the other. A plan could allow credit bidding without delivering the indubitable equivalent of the secured claim (if, for example, the plan proposed to conduct an auction on such a truncated timetable that high-value buyers could not be located); and yet a plan could offer secured creditors the indubitable equivalent of their claims without falling in subsection (b)(2)(A)(ii)'s domain (if, for example, the plan did not propose to sell assets free and clear of liens). Neither rule governs every case governed by the other. The Bankruptcy Code's language, rather than a canon, must supply the answer. *Katz*, 552 F.3d at 562.

The Third and Fifth Circuits reached this conclusion in two recent decisions. *Phila. Newspapers*, 599 F.3d 298; *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009). In *Amici*'s view, parsing section 1129(b)(2)(A) does not resolve this case, but the *Philadelphia Newspapers* and *Pacific Lumber* courts parsed it correctly. In each case, the court observed that the secured creditors' reading would impermissibly convert the

word "or," which is in the statute, to "and," which is not. *Phila. Newspapers*, 599 F.3d at 305; *Pacific Lumber*, 584 F.3d at 245-46. No more ink need be spilt.

II. An Auction Plan that Forbids Credit Bidding Is Not "Fair and Equitable"

The bedrock rule of cramdown is that a court may confirm only a plan that "does not discriminate unfairly, and is fair and equitable, with respect to" each impaired class. 11 U.S.C. § 1129(b).

When applied to evaluate the sufficiency of a proposed plan of reorganization, the phrase "fair and equitable" is to be understood according to the aims of bankruptcy law, as Congress gives them. *In re Luster*, 981 F.2d 277, 280 (7th Cir. 1992) ("When construing ambiguities in bankruptcy statutes, courts consider goals that infuse the structure of the laws – goals such as preventing a race among creditors that reduces the total value of the estate, distributing assets according to contractual and statutory entitlements, and providing natural persons with 'fresh starts' so that they again can claim the rewards of their labor."). That is the approach this Court took when it held that the absolute-priority rule is encoded in the phrase "fair and equitable," *United States v. Key*, 397 U.S. 322, 327 (1970); *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1913), long before absolute priority was codified as a prerequisite to cramdown, 11 U.S.C. § 1129(b)(2)(B).

Denying secured creditors the right to credit bid in a going-concern sale is unfair within the meaning of the Code because credit bidding maximizes the value of the estate and simultaneously ensures that a secured creditor receives the value of the property interest conferred on him under state law. Credit bidding furthers rather than detracts from the goals of bankruptcy. Absent an unusual justification – the Code terms it "cause," *see* 11 U.S.C. § 363(k) – credit bidding should be a mandatory feature of going-concern auction plans.

A. Credit Bidding Maximizes the Value of the Debtor's Estate and the Expected Recoveries of the Estate's Claimants

The principal object of bankruptcy auctions is for the debtor to "maximize the return on the collateral" by fetching the highest price for the assets up for sale. *In re Excello Press, Inc.*, 890 F.2d 896, 906 (7th Cir. 1989). Maximizing auction proceeds augments the value of the estate, thereby ensuring the highest possible recovery to the debtor's claimants. For at least three reasons, credit bidding furthers the goal of ensuring that a bankruptcy auction attracts the highest price for the debtor's assets.

First, credit bidding grows the pool of knowledgeable bidders available at auction, increasing competition for the items on the block. Increased competition, in turn, tends to increase the price of the winning bid. *See* Buccola & Keller, *supra*, at 119.

Auction optimization theory instructs that the bidders with the highest and second-highest reservation prices will determine the sale price. Competition between bidders drives the price of the asset to that of the bidder with the second-highest reservation price, at which point the high-value bidder will submit an incrementally higher topping bid, winning the auction. *Id.*; *see also Van Zelst v. Commissioner of Internal Revenue*, 100 F.3d 1259, 1262 (7th Cir. 1996) ("[T]he market price of an asset depends on the second-most-productive use to which it can be put."). Barring credit bidders from the auction house needlessly risks excluding the high-value or second-highest-value bidder, thereby reducing the expected proceeds from the bankruptcy auction. Risking a reduction in the value of the estate is a move no debtor should reasonably take.

Second, credit bidding offers an effective check against management malfeasance. Not all debtors faithfully discharge their obligation to maximize estate value. Because corporations and the people who manage them often have misaligned interests, it is hardly implausible that a debtor's officers would seek to sell the bankrupt's business to a low-value bidder in exchange for some personal remuneration that does not redound to the benefit of the enterprise as a whole. Creditors, who bear the costs of a rigged auction, are naturally inclined to prevent inefficient sales. *Phila. Newspapers*, 596 F.3d at 336-37 (Ambro, J., dissenting); Alan Schwartz, *The Enforceability of Security Interests in Consumer Goods*, 26 J.L. & Econ.

117, 126-27 (1983). Credit bidding helps them do so. In short, the best check against a fixed auction is to increase the stock of bidders interested in purchasing the debtor's collateral.

Third, credit bidding promises to reduce transaction costs, increasing the maximum bid a credit bidder is willing to submit for the assets up for sale. A creditor's alternative to credit bidding is typically to secure cash financing to participate in the auction. But financing, even for the most creditworthy borrower, is not costless. Each dollar the creditor pays to secure a loan reduces by a dollar the price he will be willing to bid on the items the debtor is selling. And reducing the maximum amount a bidder is willing to bid will plainly reduce the expected proceeds from an auction. Since a would-be credit bidder is entitled to the cash proceeds of the amount he intends to bid on credit, there is no sense forcing creditors to incur costs shuffling money.

Opponents of credit bidding often claim that the procedure disserves the interests of the estate by dissuading cash bidders from participating at the bankruptcy auction. On this view, would-be cash bidders who would otherwise participate in an auction observe the size of the debtor's liability to the credit bidder. To the extent the credit – which will serve as the creditor's currency at auction – eclipses a would-be cash bidder's valuation of the assets, that party knows that the credit bidder can easily outbid him. He may thus elect to forgo the auction altogether rather than compete with the credit bidder. If other

cash bidders behave in kind, credit bidding could actually reduce the number of auction participants, depressing the ultimate winning bid.

This objection is wide of the mark, as there is nothing about the argument specific to credit bidding. Rather, the argument rests on the notion that bidders with deep pockets may deter bidders with limited resources. "For instance, if a would-be bidder knows that Warren Buffett plans to attend an auction, she is also surely aware that Buffett can top her reservation price for any or all of the assets on the block. Yet nobody proposes to ban wealthy *cash* bidders from participating in a bankruptcy auction." *Philadelphia Newspapers*, 599 F.3d at 321 n.4 (Ambro, J., dissenting) (quoting Buccola & Keller, *supra,* at 123).

That, of course, is in keeping with rational economic behavior. "Would-be bidders understand that a deep-pocketed player's ability to top their reservation price does not imply a willingness to do so. Warren Buffett did not become wealthy by overpaying for things, so it is possible, indeed, probable, that his reservation price for an asset at auction will be beneath that of another buyer. And buyers know this in advance." *Id.* The same logic holds for credit bidders. By bidding with credit, the secured creditor surrenders the cash he would otherwise receive for any offer beneath his bid. Would-be cash buyers therefore know that a credit bidder has no incentive to bid all of his credit unless he *actually* values the assets at that price. That the secured creditor may not highly prize the debtor's assets should prove

sufficient to bring interested cash bidders to the auction.

B. Denying a Secured Creditor's Ability to Credit Bid Disparages Property Rights without Valid Bankruptcy Purpose

Butner v. United States holds that the determination of property rights in the estate of a bankrupt generally falls to state law. 440 U.S. at 54-55. The case featured a dispute over the right to rents collected on the debtor's mortgaged property. By the time it reached this Court, the fight was more generally about what source of law would govern the dispute – state law or the bankruptcy judge's sense of equity. Observing that there is no reason to upset property interests "unless some federal interest requires a different result," the Court held that state law provides the rule of decision absent congressional say-so. *Ibid*.

Outside of bankruptcy, credit bidding safeguards a secured creditor's property interest in his collateral. Upon the debtor's default, a secured creditor may repossess collateral and auction it in a commercially reasonable manner, keeping proceeds up to the face value of the secured claim. Uniform Commercial Code §§ 9-610(a)-(c); 9-615(a). Credit bidding has long been among the features of such a commercially reasonable sale, and the same rule typically holds for a mortgagee who forecloses on real estate after default. *E.g.*, *Freedom Mortgage*, 569 F.3d at 670.

Petitioners insist that secured creditors get all the protection they need through the requirement that a plan give them the "indubitable equivalent" of the secured claim. *See* 11 U.S.C. § 1129(b)(2)(A)(iii). On their view the bankruptcy judge should find, without allowing credit bids (and presumably according to a judicial valuation of the assets), that the proposed plans indubitably give the equivalent value of the secured creditors' property interest in the collateral. Such a procedure would be unwise. To be sure, judicial valuation is an established part of bankruptcy practice. 11 U.S.C. § 506(a). Sometimes a bankruptcy court must assess the value of a secured claim without the aid of a sale. In a *bona fide* reorganization, where the debtor proposes to keep its assets and emerge from chapter 11 as a going concern – but with a clean balance sheet – there is often no alternative. No sale means no market to determine what the secured claims are worth. A neutral judge's estimate is the best measure. But open auction, where feasible, is better. *203 N. LaSalle*, 526 U.S. at 456-58.

Given the *Butner* principle, Petitioners must explain why a property interest traditionally protected by the power to credit bid in a commercially reasonable sale should be altered when the auction occurs as part of a plan of reorganization. Bankruptcy law does of course suspend the secured creditor's right, generally established under state law, to repossess and sell collateral on his own initiative. 11 U.S.C. § 362(a). But it does so to prevent a race to assets

that would destroy going-concern value for all. The justification for the stay's suspension of repossession-and-sale rights disappears once the debtor has marshaled assets and elected to conduct an orderly sale. Now the collective-action problem is solved; the bankruptcy-specific reason for suspending state-law rights vanishes. The debtor's objective should be to maximize the price its assets fetch, and, as shown above, it matters not at all whether the currency used is cash or credit.

CONCLUSION

The judgment of the Seventh Circuit should be affirmed.

Respectfully submitted,

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