Testimony Before The American Bankruptcy Institute Commission To Study The Reform Of Chapter 11

Danielle Spinelli
Partner, Wilmer Cutler Pickering Hale and Dorr LLP

Field Hearing
Turnaround Management Association Annual Meeting
November 3, 2012
Boston, MA

My name is Danielle Spinelli. I am a partner in the appellate and Supreme Court litigation and bankruptcy and creditor rights litigation practice groups at Wilmer Cutler Pickering Hale and Dorr LLP, in the firm's Washington, D.C. office. My practice focuses on representation of parties and amici in the U.S. Supreme Court, in the federal and state appellate courts, and in trial-level matters involving complex legal questions. Although I have handled matters in a wide variety of substantive areas, a major focus of my practice has been appeals and other disputes raising novel and complex bankruptcy problems.

In addition to handling such cases in the courts of appeals, I have represented parties or amici in many of the Supreme Court's recent bankruptcy cases, including, most recently, *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012); *Stern v. Marshall*, 131 S. Ct. 2594 (2011) (successfully representing respondent in dispute over scope of bankruptcy court's authority under Article III); and *Schwab v. Reilly*, 130 S. Ct. 2652 (2010) (successfully representing chapter 7 trustee in dispute over interpretation of rules governing exemptions). In *RadLAX*, I was counsel of record for an amicus brief filed by the Loan Syndications and Trading Association (LSTA) and nine other financial-institution trade organizations supporting secured creditors' right to credit-bid in asset sales under a chapter 11 plan.[1] I also represent the LSTA in connection with its participation in the process of information-gathering, research, and debate the Commission has undertaken.

I would like to thank the Commission for giving me the opportunity to testify today, and more broadly for initiating and pursuing the incredibly demanding, but very important, work of reassessing chapter 11 in light of the many changes in the world of business and finance since 1978. In particular, I am very grateful for the Commission's efforts to solicit the views of all affected constituencies in addressing the complex question of what bankruptcy policies best serve not only participants in chapter 11 bankruptcies, but also participants in the broader realm of commercial dealings, in today's world. It is an honor to participate, even in a minor way, in that critical work.

[1] Brief for the Loan Syndications and Trading Association et al. as Amici Curiae in Support of Respondent, *RadLAX Gateway Hotel LLC v. Amalgamated Bank*, No. 11-166 (filed Mar. 2012). My full biography is available at http://www.wilmerhale.com/danielle_spinelli/.

I. Introduction

In its mission statement, the Commission states that "the expansion of the use of secured credit" has "affected the effectiveness of the current Bankruptcy Code" and that the Commission intends to "propose reforms to chapter 11 ... that will better balance the goals of ... effective reorganization of business ... and the maximization and realization of asset values for all creditors and stakeholders."[2] While I appreciate that the Commission is currently in information-gathering mode and has not reached the stage of considering any particular reforms, there does appear to be widespread concern that the expansion of secured credit has had a deleterious effect on the bankruptcy process, and some bankruptcy practitioners and academics have proposed consideration of revisions to the Bankruptcy Code that would provide less robust protections for the non-bankruptcy rights of secured creditors.[3]

Previous witnesses who have expertise regarding the debt markets and the lending industry have spoken about the risks of weakening secured creditors' rights in bankruptcy.[4] While doing so might provide more flexibility to debtors who come into bankruptcy with few unencumbered assets, such changes would inevitably increase the cost and constrict the availability of credit, particularly to non-investment-grade companies, and thus have a profound effect on businesses outside bankruptcy and the jobs that those businesses have created. I join those witnesses in urging the Commission to consider the effect of such proposed reforms on the broader market for credit and the U.S. economy as a whole when deciding whether bankruptcy policy justifies such changes.

My testimony today, however, focuses on a particular aspect of the treatment of secured creditors: their right to credit-bid their claims in sales of their collateral either under Section 363 of the Code or under a chapter 11 plan. The Supreme Court held in *RadLAX* that Section 1129 of the Bankruptcy Code requires that secured creditors be permitted to credit-bid their claims in sales of their collateral under a plan just as they can in a Section 363 sale. But the Court examined only what it found to be the plain text of Section 1129, and did not consider either the way in which credit-bidding fits into the Code's broader structure of protections for secured creditors or the policy arguments the parties and amici raised for and against credit-bidding. Since the Court's decision, at

---

[2] ABI Commission to Study the Reform of Chapter 11, *Purpose of the Commission*, *available at* http://commission.abi.org/purpose-commission.

[3] On the specific topic of credit-bidding, *see infra* note 5.

[4] *See, e.g.*, A.J. Murphy, *Testimony Before the ABI Commission To Study the Reform of Chapter 11* (Oct. 17, 2012), *available at* http://commission.abi.org/sites/default/files/statements/17oct2012/Murphy_testimony_final.DOC; Lee Shaiman, *Testimony Before the ABI Chapter 11 Reform Commission* (Oct. 17, 2012), *available at* http://commission.abi.org/sites/default/files/statements/17oct2012/Final_Shaiman_Written_Testimony.pdf.

least two academic articles have called for reexamining credit-bidding and have argued that credit-bidding should not be required.[5]

In this written submission, I will briefly discuss the history of credit-bidding and related concepts before 1978, summarize the way in which credit-bidding fits into the overall structure of chapter 11 as it exists today, examine the arguments for and against the practice, and respond to the most recent proposals to eliminate credit-bidding. In short, my view is that eliminating the right to credit-bid would undermine the fundamental principle, which has a long history and which is embodied in a carefully reticulated set of provisions in the current Code, that secured creditors are entitled, at a minimum, to the value of their collateral. It would therefore adversely affect the availability and cost of credit. Moreover, no one has yet persuasively articulated how depriving secured creditors of the right to credit-bid would have any meaningful countervailing benefits. To the contrary, barring credit-bidding would almost certainly reduce the value an asset sale realizes for the estate, and would serve primarily to assist debtors in steering assets into the hands of insiders or other non-arm's-length bidders who seek to pay less than fair value.

II. A Brief History Of Credit-Bidding And Related Issues Before 1978

Credit-bidding, like other rights pertaining to secured credit, is not a creation of the Bankruptcy Code. Rather, state law has typically recognized secured creditors' entitlement to credit-bid the debt owed to them at a foreclosure sale as a necessary incident of their security interest.[6] Credit-bidding is likewise generally accepted as a secured creditor's entitlement in judicial or non-judicial sales pursuant to Article 9 of the Uniform Commercial Code.[7] That is not surprising: The very purpose of a security interest is to ensure that, if a creditor is not paid in full, it can take its collateral. Restricting a creditor's ability to participate in an auction of its collateral undermines that basic bargain.

A. The Frazier-Lemke Act Decisions

Pre-Bankruptcy Code decisions generally reflect that basic understanding of the nature of a security interest. Indeed, when the issue came before the Supreme Court in

---

[5] *See* Jacob A. Kling, *Rethinking 363 Sales*, 17 Stan. J.L. Bus. & Fin. 258 (2012); Charles J. Tabb, *Credit Bidding, Security, and the Obsolescence of Chapter 11*, U. Ill. L. Rev. (forthcoming 2012), *available at* http://ssrn.com/abstract=2019018.

[6] *See* Jason S. Brookner, *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, 139 & n.68 (2011) ("Case law and statutes in 42 states and the District of Columbia either expressly or implicitly authorize or recognize the right to credit bid.") (collecting authorities); Alan S. Resnick, *Denying Secured Creditors the Right to Credit Bid in Chapter 11 Cases and the Risk of Undervaluation*, 63 Hastings L.J. 323, 331 (2012).

[7] *See* Donald M. Bernstein et al., *The Logic and Limits of Credit Bidding by Secured Creditors Under the Bankruptcy Code* 5-6, N.Y.U. Law Workshop of Bankruptcy and Business Reorganization (2011), *available at* http://ssrn.com/abstract=1975932.

1935 in *Louisville Joint Stock Land Bank v. Radford*,[8] the Court recognized that a secured creditor's right to bid at a sale of its collateral was a fundamental part of the security interest itself, and, like other rights appurtenant to a security interest, potentially had a constitutional dimension. *Radford* struck down the Frazier-Lemke Act, which sought to give mortgage relief to farmers by providing that under certain circumstances a farmer could purchase a mortgaged property at an appraised valuation, strip the lender's lien, and discharge his obligation to the lender.[9] Justice Brandeis, for the Court, explained: "The right of the mortgagee to insist upon full payment before giving up his security has been deemed of the essence of a mortgage. … To protect his right to full payment or the mortgaged property, the mortgagee was allowed to bid at the judicial sale on foreclosure."[10] By stripping the lender of these basic rights, Justice Brandeis concluded, the Frazier-Lemke Act took its property without just compensation.[11]

Two years later, in *Wright v. Vinton Branch of Mountain Trust Bank*,[12] the Court considered and upheld against constitutional challenge a revised version of the Frazier-Lemke Act that restored the lender's right to retain its lien until the debt was paid in full, along with its right to realize on the security through a judicial sale and to bid at that sale.[13] The Court held that the more modest provisions of the revised Act permitting the courts to stay the sale of mortgaged property, unlike the sweeping provisions of the original Act, did not contravene the lender's constitutional rights.[14] The Court emphasized that the new Act "sought to preserve to the mortgagee all of [its] rights so far as essential to the enjoyment of [its] security," including "[t]he 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."[15]

Subsequently, in *Wright v. Union Central Life Ins. Co.*,[16] the Court interpreted the revised Frazier-Lemke Act to permit a debtor to redeem a mortgaged property at a value fixed by the court, without a public sale being held (even though the Act provided that the secured creditor had a right to a public sale of its collateral on request).[17] In a decision difficult to reconcile with the two earlier Frazier-Lemke Act cases, the Court found no constitutional difficulty with such a scheme, commenting that "the creditor will not be deprived of the assurance that the value of the property will be devoted to the

---

[8] 295 U.S. 555 (1935).

[9] *Radford*, 295 U.S. at 575-576.

[10] *Id.* at 579-580.

[11] *Id.* at 601-602.

[12] 300 U.S. 440 (1937).

[13] *Id.* at 458-459.

[14] *See id.* at 470.

[15] *Id.* at 457.

[16] 311 U.S. 273 (1940).

[17] *See id.* at 275-276.

payment of its claim," because "if the debtor did redeem pursuant to that procedure, he would not get the property at less than its actual value."[18] Although the Court cited *Wright v. Vinton Branch* for the latter proposition, that case had actually reasoned that the borrower would not obtain the property for less than its actual value *because* the creditor had the right to request a public sale and could "by bidding at such sale fully protect his interest."[19] One could argue that *Wright v. Union Central* "undermines any serious argument that a lienholder enjoys a constitutional right to make a credit bid."[20] Yet *Wright v. Union Central* purported to follow, not to overrule, the two previous Frazier-Lemke Act cases, and the overall import of the three decisions, considered together, is less than clear in that regard.

The Court was undeniably more solicitous of constitutional protections for economic interests in the 1930s than it has typically been since. Yet the Court has more recently reaffirmed the basic holding of *Radford* that permitting a debtor to acquire liened-up property for "less than its fair market value," thus retroactively impairing the rights attendant on the creditor's security interest, raised serious constitutional concerns under the Takings Clause.[21]

Ultimately, what comes through clearly from all of these decisions—and, with regard to credit-bidding, may be as significant as their constitutional holdings—is the notion that the "essence" of a security interest, as Justice Brandeis put it, is the secured creditor's ability, if not paid in full, to acquire its collateral itself rather than being forced to relinquish the collateral to the debtor or a third party for less than fair market value. What is left unclear is what constitutes "fair market value" for purposes of these decisions, and whether and under what circumstances a judicial appraisal can supplant a valuation through a public sale.

B. *In re Murel Holding Corp.* And Indubitable Equivalence

The same basic understanding of secured creditors' rights drove one of the foundational decisions construing the 1898 Act, which is still highly relevant to interpretation of the Code today, *In re Murel Holding Corp.*[22] In *Murel*, Judge Learned Hand interpreted Chapter X of the Act's predecessor provisions to today's "cram down" provisions for nonconsenting classes of secured claims. The statute required that such a class of creditors receive "adequate protection for the realization by them of the full value of their interest, claims, or liens," and provided four methods for doing so, the last being

[18] *Id.*

[19] *Wright*, 300 U.S. at 468.

[20] Tabb, *supra* note 5, at 11.

[21] *See United States v. Security Indus. Bank.*, 459 U.S. 70, 76-77 (1982) (construing Section 522(f) of the Bankruptcy Code to apply only prospectively in light of constitutional concerns raised by retroactive application).

[22] 75 F.2d 941 (2d Cir. 1935) (L. Hand, J.)

essentially a catch-all provision permitting the court "equitably and fairly" to "provide such [adequate] protection" when one of the three specific methods was not used.[23]

Judge Hand explained:

> In construing so vague a grant, we are to remember not only the underlying purposes of the section, but the constitutional limitations to which it must conform. It is plain that "adequate protection" must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; *he wishes to get his money or at least the property*. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by *a substitute of the most indubitable equivalence*.[24]

Like the Supreme Court in *Radford*, but more pithily, Judge Hand identified the "essence" of a security interest as the ability "to get [the] money or at least the property," and suggested that a statute that provided the secured creditor with anything less than the "indubitable equivalent" of that basic right might overstrip constitutional limits. Again, the decision's lasting significance may lie as much in Judge Hand's formulation of the basic rights of secured creditors—which has been incorporated into the current Bankruptcy Code—as in any constitutional component.

III. CREDIT-BIDDING IN THE CURRENT BANKRUPTCY CODE

As the above discussion suggests, credit-bidding is not best understood or analyzed as a free-standing right, but as a means of enforcing the bargain the secured creditor made "to get his money or at least the property."[25] Accordingly, the provisions for credit-bidding in the current Bankruptcy Code can only be fully understood as part of a larger, highly reticulated set of protections designed to ensure that, to the extent possible, secured creditors retain the benefit of that basic bargain, and that creditors are not "cashed out" at less than the fair market value of their collateral. While the Commissioners are of course familiar with the statutory scheme, I offer a brief summary below as background for further analysis of the credit-bidding issue.

---

[23] *Id.* at 942 (quoting 11 U.S.C. § 207(b)(5)). Unlike today's Code, the Act made no express reference to credit-bidding, and in fact provided that one method of giving "adequate protection" was payment in cash of the judicially appraised value of the lien. *See id.* When collateral was sold under the Act, however, the secured creditor's right to credit bid was apparently generally accepted. *See* 2 *Collier on Bankruptcy* ¶ 363.09 (Resnick et al. eds., 4th ed. 2011) ("The right of a lienholder whose lien was not in *bona fide* dispute to bid at a sale free and clear of liens was generally recognized under [pre-Code] law[.]"); Bernstein et al., *supra* note 7, at 6-7; Resnick, *supra* note 6, at 331.

[24] 75 F.2d at 942 (emphases added).

[25] *Id.*

A. The Treatment Of Secured Creditors' Claims And The Section 1111(b) Election

1. Section 506(a)

The Code's provisions for treatment of secured creditors' claims begin with Section 506(a), which provides that "[a]n allowed claim of a creditor secured by a lien on property in which the estate has an interest… is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property … and is an unsecured claim to the extent that the value of such creditor's interest … is less than the amount of such allowed claim."[26] Section 506(a) bifurcates the claims of undersecured creditors, giving such a creditor a secured claim in the value of its collateral and an unsecured claim for any remaining debt. So, for instance, if a debtor owes $100,000, secured by a warehouse valued at $80,000, the lender has a secured claim for $80,000 and an unsecured claim for $20,000.

Section 506(a) provides for judicial valuation of the collateral, but, recognizing that valuation is an uncertain and changing business and that a fair valuation is crucial to protecting the creditor's rights, adds the proviso that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."[27] The committee notes to the 1978 Code explain: "To illustrate, a valuation early in the case in a proceeding under sections 361-363 would not be binding upon the debtor or creditor at the time of confirmation of the plan."

2. Section 1111(b)

Judicial valuation of its collateral, and thus of its secured claim, as Section 506(a) contemplates, can be risky for the secured creditor. If, for whatever reason, the court undervalues the collateral, and the debtor is unable to pay unsecured claims in full, the secured creditor will receive less than it is entitled to. In the example above, for instance, if the lender believes the warehouse is worth $80,000, but the court values it at only $60,000, application of Section 506(a) could force the lender to accept $60,000 in satisfaction of its secured claim, rather than its collateral, even though the lender values the collateral more highly. That is, the secured creditor could end up receiving neither his money nor the property, but instead some lesser value. To address this potential problem, Chapter 11 provides a mechanism, in Section 1111(b), by which secured creditors can, under certain circumstances, "opt out" of judicial valuation of their secured claim.

Section 1111(b) provides:

---

[26] 11 U.S.C. § 506(a).

[27] *Id.*

(1) (A) A claim secured by a lien on property of the estate shall be allowed or disallowed … the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless—

(i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or

(ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.

(B) A class of claims may not elect application of paragraph (2) of this subsection if—

(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or

(ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.

(2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.[28]

Section 1111(b) does two things. *First*, it provides that, in bankruptcy, a secured creditor has a recourse claim against the estate even if, outside bankruptcy, its claim is non-recourse, unless (i) the relevant class "elects application of paragraph (2)" or (ii) the creditor's collateral is sold under Section 363 or under a chapter 11 plan.

Second, it provides that a secured creditor may elect to have its entire allowed claim treated as secured, but must relinquish any deficiency claim. Thus, in the example above, if the creditor owed $100,000 secured by a $80,000 warehouse made the Section 1111(b) election, it would have a secured claim for $100,000 and no unsecured claim, even if it recovers less than $100,000 on its secured claim. A class of secured creditors may make the Section 1111(b) election unless (i) their security interests have only inconsequential value or (ii) their collateral is sold under Section 363 or under a chapter 11 plan.[29]

Section 1111(b) was enacted in part in response to a pre-Code decision, *In re Pine Gate Associates, Ltd.*,[30] in which a bankruptcy court permitted a debtor to keep collateral securing an undersecured creditor's non-recourse claim and cash out the creditor at the

[28] 11 U.S.C. § 1111(b).

[29] *See generally* 7 *Collier on Bankruptcy* ¶ 1111.03; *see also In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 333-334 (3d Cir. 2010) (Ambro, J., dissenting); Resnick, *supra* note 6, at 327-328.

[30] 2 Bankr. Ct. Dec. 1478 (Bankr. N.D. Ga. 1977).

judicially determined value of the collateral.[31] *Pine Gate* was widely criticized because it put the entire risk of judicial undervaluation on the secured creditor and denied the creditor any possibility of sharing in value realized from appreciation of the collateral.[32]

Section 1111(b) was intended to remedy the *Pine Gate* problem by ensuring that, subject to certain exceptions, both recourse and non-recourse creditors could "opt out" of judicial valuation of their secured claims, give up any deficiency claim, and instead elect to have their entire claim treated as secured.[33] The Section 1111(b) election thus represents an important protection against undervaluation of a creditor's secured claim.

Section 1111(b) does not apply, however, in cases in which the collateral is sold, either through a Section 363 sale or under a plan. When collateral is sold, the Code gives creditors a different protection against undervaluation—the right to credit-bid. Indeed, that was Congress' express rationale for creating the sale exception to Section 1111(b). "Sale of property … 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."[34] Put differently, if the collateral is sold, the "creditor has the opportunity to protect its position. It may bid its debt at the sale of the collateral and recover the collateral. This ability gives it the benefit of its bargain."[35]

B. Credit-Bidding

As the discussion above suggests, credit-bidding is relevant in two situations—the sale of property under Section 363 and the sale of property under a chapter 11 plan that is being "crammed down" a dissenting class of secured creditors under Section 1129.

1. Section 363

Section 363(b) permits a trustee or debtor-in-possession to sell estate property outside the ordinary course of business after notice and a hearing.[36] In certain circumstances, such a sale may be conducted free and clear of existing liens.[37] The statute expressly gives secured creditors the right to credit-bid at such a sale, providing that "unless the court for cause orders otherwise the holder of [a claim secured by

---

[31] *See* S. Rep. No. 989, 95th Cong., 2d Sess. 5 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5791 (provision "answers the nonrecourse loan problem … in response to" *Pine Gate*); Michael E. Rubinger & Gary W. Marsh, *"Sale of Collateral" Plans Which Deny A Nonrecourse Undersecured Creditor the Right to Credit Bid:* Pine Gate *Revisited*, 10 Bankr. Dev. J. 265, 269-271 (1994).

[32] *See* Rubinger & Marsh, *supra* note 31, at 270.

[33] *See id.*; 7 *Collier on Bankruptcy* ¶ 1129.03[4][c][ii][B] ("Congress specifically legislated to prevent … the debtor" from "retain[ing] the property subject to the mortgage by paying an appraised value, over the objection of the secured creditor.").

[34] 124 Cong. Rec. 32,407.

[35] 7 *Collier on Bankruptcy* ¶ 1111.03[3][b].

[36] 11 U.S.C. § 363(b)(1).

[37] *Id.* § 363(f).

property being sold] may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property."[38]

As noted, if collateral is sold at a Section 363 sale, the undersecured creditor can no longer elect under Section 1111(b) to have its entire claim treated as secured. Rather, Section 363(k) offers the creditor a different protection against undervaluation: the ability to credit-bid at the sale. To accomplish that end, the creditor is entitled to bid its entire claim, not merely the secured portion.[39] If the creditor believes that its collateral will be sold for less than it is worth to the creditor, the creditor can bid up to the amount of its claim and take possession of the collateral. In our example, the creditor owed $100,000 who believes its collateral is worth $80,000 could outbid a potential buyer willing to pay only $70,000, giving the creditor the benefit of its bargain, resulting in the collateral going to the party who values it most highly, and maximizing the estate's recovery.[40]

As noted, a court can deny a secured creditor the right to credit-bid "for cause," although that power has been used sparingly, typically in situations involving a dispute regarding the validity of the creditor's lien, collusion, failure to abide by sale procedures, or prejudice to the rights of senior or *pari passu* lienholders who will not be compensated.[41]

2. Section 1129

Section 1129 provides that, to be confirmed over the objection of a dissenting class of creditors, a plan must be "fair and equitable" to that class.[42] To be fair and equitable to a class of secured claims, a plan must provide for one of three forms of treatment:

> (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

---

[38] *Id.* § 363(k).

[39] *See, e.g.*, *In re SubMicron Sys. Corp.*, 432 F.3d 448, 459-461 (3d Cir. 2006). Indeed, it would make no sense to say that the creditor can bid only the secured portion of its claim, since the price realized at the auction, by definition, is the value of its secured claim.

[40] *See, e.g.*, Resnick, *supra* note 6, at 331-332.

[41] *See* Bernstein et al., *supra* note 7, at 8-9.

[42] 11 U.S.C. § 1129(b)(1).

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.[43]

Clause (i). Put more simply, "Under (i), the reorganized debtor keeps [or transfers] the property and may be allowed to stretch out the repayment of the debt beyond the period allowed by the loan agreement, but the lien remains on the property until the debt is repaid."[44] In other words, the debtor can force a refinancing. Because of Section 1111(b), however, an undersecured creditor retains the right to payment of the full face value of its loan, although payment can be deferred, and retains the full value of its lien. For instance, the creditor with a loan of $100,000 secured by property worth $80,000, if it has made the Section 1111(b) election, would be entitled to cash payments of $100,000 over time that have a discounted net present value of $80,000, and it would keep its lien on the property until the payments were made. While the collateral is still subject to judicial valuation, the creditor who has made the Section 1111(b) election cannot be cashed out at that valuation and stripped of its lien, but keeps its lien until it has been paid in full, albeit over a longer time period.[45]

Clause (ii). "Under (ii), the debtor auctions the property free and clear of the mortgage but the creditor is allowed to 'credit bid,'" by virtue of the incorporation of Section 363(k).[46] The creditor's lien attaches to the proceeds of the sale and is then treated under clause (i) or (iii). In practice, this typically means that, unless the creditor

[43] *Id.* § 1129(b)(2)(A).

[44] *In re River East Plaza, LLC*, 669 F.3d 826, 828 (7th Cir. 2012) (Posner, J.)

[45] In *River East*, the Seventh Circuit rejected a plan proposed by an underwater real estate developer that purported to satisfy its lender's $38 million claim, secured by the real estate, by substituting a lien on Treasury bonds worth $13.5 million—the debtor's estimate of the building project's present value. *See id.* at 830. The debtor argued that the substitute lien provided the creditor with the "indubitable equivalent" of its secured claim. Judge Posner, writing for the court, rejected that contention, explaining that "River East's aim may have been to cash out [its creditor's] lien in a period of economic depression and reap the future appreciation in the building's value when the economy rebounds. Such a cashout is not the indubitable equivalent of a lien on the real estate, and to require it would be inconsistent with section 1111(b) of the Code, which allows the secured creditor to defeat such a tactic by writing up his secured claim to the full amount of the debt, at the price of giving up his unsecured claim to the difference between the current value of the debt and of the security." *Id.* at 832-833. The *River East* plan, which attempted to use clause (iii)'s "indubitable equivalent" provision to evade the specific requirements of clause (i) of the cram-down provisions, was a kissing cousin to the plan addressed by the Supreme Court in *RadLAX*, and discussed further below, which attempted to use clause (iii) to evade the specific requirements of clause (ii).

[46] *Id.* at 828.

buys the collateral itself, the creditor receives the proceeds of the sale, which by definition constitute both the value of the creditor's secured claim and the value of its security interest for purposes of clause (i). As noted above, when a plan auctions collateral under clause (ii), the secured creditor is not allowed to make the Section 1111(b) election, and the value of its secured claim thus remains capped at the value of its security interest pursuant to Section 506(a).[47]

Just as Section 1111(b) operates in the context of clause (i) to ensure that the creditor is protected against undervaluation, however, credit-bidding does the same in the context of clause (ii) (as it also does in Section 363 sales). As the Supreme Court put it in *RadLAX*, "The ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price. It enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan."[48] Again, if other bidders offer less than the creditor believes the collateral to be worth, the creditor can step in, without the need to raise additional cash, and place a higher bid, up to the amount of its claim, thus ensuring that the property goes to the bidder who values it most highly and maximizing the estate's recovery.

Clause (iii). Finally, under clause (iii), the debtor can provide the secured creditor with the "indubitable equivalent" of its secured claim. The "indubitable equivalent" concept, of course, comes from Judge Hand's statement in *Murel* that a secured creditor "wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that ..., unless by a substitute of the most indubitable equivalence."[49]

The legislative history suggests, consistent with the genesis of the concept, that only a few plans that did not comply with clauses (i) or (ii) would meet the "indubitable equivalent" standard. "Abandonment of the collateral to the creditor" would satisfy the requirement, as would a lien on substitute property of equivalent value.[50] By contrast, "present cash payments less than the secured claim would not satisfy the standard."[51] Thus, assuming it has made the Section 1111(b) election, a creditor holding a $100,000 note and a security interest valued by the court at $60,000 could not be cashed out at $70,000. Again, the creditor is protected against potential undervaluation of its collateral by the right to insist on receiving either the collateral itself or collateral of indubitably equivalent value (presumably, a very difficult standard to meet in light of the inherent uncertainties of valuation).

[47] *See* 11 U.S.C. § 1111(b)(1)(B)(ii).

[48] 132 S. Ct. at 2070 n.2; *see also, e.g.,* Resnick, *supra* note 6, at 335.

[49] 75 F.2d at 942.

[50] 124 Cong. Rec. 32,407.

[51] *Id.*; *see also* 7 *Collier on Bankruptcy* ¶ 1129.04[2][c].

IV. THE SPLIT AMONG THE COURTS OF APPEALS AND THE *RADLAX* DECISION

For thirty years after the enactment of the Code, it was well-accepted that secured creditors were entitled to credit-bid at free-and-clear sales of their collateral under chapter 11 plans, just as they were in Section 363 sales.[52] In the last few years, however, several debtors tested that proposition by attempting to confirm plans that would have barred secured creditors from credit-bidding at such sales, notwithstanding the requirements of clause (ii), on the theory that the creditors would be paid cash that would constitute the "indubitable equivalent" of their secured claims under clause (iii). *RadLAX*, of course, rejected such plans, holding that credit-bidding was required at any free-and-clear sale of collateral under a plan.

Before the Supreme Court decided *RadLAX*, the question had divided the courts of appeals. The Third and Fifth Circuits sided with debtors, holding that credit-bidding was not required in a free-and-clear sale of collateral under a plan if the plan provided the secured creditors with the indubitable equivalent of their claims.[53] In *RadLAX* itself, however, the Seventh Circuit came to the opposite conclusion.[54]

I will not provide a detailed discussion of the court of appeals cases, which is available elsewhere,[55] but will briefly summarize *Philadelphia News*, which arose on a typical set of facts and illustrates the interpretation of the statute debtors favored.[56]

Philadelphia News involved a debtor that wanted to sell its main assets, two daily Philadelphia newspapers, to a stalking-horse bidder that was majority-owned by shareholders or former shareholders of the debtor.[57] The debtor's prepetition lenders were owed approximately $318 million, secured by a lien on substantially all the debtor's assets.[58] The plan proposed to give the lenders about $67 million, which the debtor intended to argue at plan confirmation was the "indubitable equivalent" of the lenders' secured claim.[59] To ensure that the stalking-horse bidder won the auction, the debtor wanted to bar its secured lenders from credit-bidding.

---

[52] *See Philadelphia News*, 599 F.3d at 319 (Ambro, J., dissenting); Tabb, *supra* note 5, at 19.

[53] *See Philadelphia News*, 599 F.3d 298; *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009).

[54] *See In re River Road Hotel Partners, LLC*, 651 F.3d 642 (7th Cir. 2011).

[55] *See, e.g.*, Bernstein et al., *supra* note 7, at 11-18; Brookner, *supra* note 6, at 129-135; 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, 558-562 (2010); Vincent S.J. Buccola & Ashley J. Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 Geo. Mason L. Rev. 99, 109-114 (2010); Resnick, *supra* note 6, at 335-352; Tabb, *supra* note 5, at 19-30.

[56] WilmerHale represented certain secured creditors in attempting to obtain en banc review of the *Philadelphia News* decision.

[57] *See Philadelphia News*, 599 F.3d at 301.

[58] *See id.* at 302.

[59] *See id.*

A divided panel of the Third Circuit examined the language, context, and purpose of the cram-down provisions. The panel majority concluded that the statutory language was "unambiguous": "The use of the word 'or' in this provision operates to provide alternatives—a debtor may proceed *under* [clause] (i), (ii), *or* (iii), and need not satisfy more than one."[60] Judge Smith, concurring, added: "I simply cannot look past the statutory text .... Section 1129(b)(2)(A) uses the word 'or' to separate its [clauses] .... Thus, satisfaction of *any* of the three [clauses] is sufficient."[61] Accordingly, the majority reasoned, the statute plainly allowed a debtor to proceed under clause (iii)'s indubitable equivalent standard with a free-and-clear sale of collateral that bars credit-bidding.[62]

The *Philadelphia News* majority drew a spirited dissent from Judge Ambro, a former bankruptcy practitioner, who contended that the statute had more than one plausible interpretation,[63] but that the better reading favored the secured creditors. He argued that "Congress did not list the three alternatives as routes to cramdown confirmation that were universally applicable to any plan, but instead as distinct rules that apply specific requirements depending on how a given plan proposes to treat the claims of secured creditors."[64] That is, in Judge Ambro's view, clause (ii) governed *all* free-and-clear sales of collateral under a plan, and clause (iii) was simply inapplicable to such plans.[65] While either reading of the language was plausible when the statutory text was viewed in isolation, Judge Ambro contended that canons of statutory interpretation—in particular, the canon that specific provisions prevail over general ones—and the context provided by the Code as a whole supported his construction.[66] After examining in detail the interlocking provisions of the Code governing secured claims, Judge Ambro concluded that credit-bidding was an integral "part of a comprehensive arrangement enacted by Congress to avoid the pitfalls of undervaluation" of secured claims, "and thereby ensure that the rights of secured creditors are protected while maximizing the value of the collateral to the estate."[67]

Following on the heels of *Philadelphia Newspapers*, debtors in *RadLAX*—developers of a hotel at the Los Angeles airport who had borrowed heavily and then run out of funds—proposed a very similar plan. Debtors proposed to sell the hotel and related assets free and clear of its lenders' liens in an auction with a stalking-horse bidder and no credit-bidding, and to provide the lenders with the "indubitable equivalent" of their claims out of the sale proceeds.[68] The Seventh Circuit concluded that, although the

[60] *Id.* at 305.

[61] *Id.* at 319 (Smith, J., concurring).

[62] *Id.* at 313-314 (majority).

[63] *Id.* at 322 (Ambro, J., dissenting).

[64] *Id.* at 325.

[65] *Id.* at 327.

[66] *Id.* at 328-334.

[67] *Id.* at 334.

[68] *River Road*, 651 F.3d at 644-645.

statutory language was not plain, the better reading of the statute barred such a plan for the reasons articulated in Judge Ambro's *Philadelphia News* dissent.[69]

The Supreme Court granted certiorari to resolve the circuit split. The parties and respondent's *amici* presented arguments focusing not only on the text of the cram-down provisions, but also on the overall structure of the Bankruptcy Code's protections for secured creditors and the role credit-bidding plays in that structure.[70] The Court, however, confined its analysis to the text of Section 1129(b)(2)(A). Like the Third Circuit majority, the Supreme Court concluded that the text of Section 1129(b)(2)(A) was unambiguous.[71] Unlike the Third Circuit, the Court concluded that the statutory text unambiguously *precluded* debtors from attempting to bar credit-bidding at a free-and-clear sale of creditors' collateral.

In an opinion written by Justice Scalia, the Court rejected the debtors' reading of the statute as "hyperliteral and contrary to common sense."[72] Relying on the "commonplace of statutory construction that the specific governs the general,"[73] the Court reasoned that "clause (ii) is a detailed provision that spells out the requirements for selling collateral free of liens, while clause (iii) is a broadly worded provision that says nothing about such a sale. ... [T]he 'general language' of clause (iii), 'although broad enough to include it, will not be held to apply to a matter specifically dealt with' in clause (ii)."[74] That is, of Section 1129(b)(2)(A)'s three clauses, "(i) is the rule for plans under which the creditor's lien remains on the property, (ii) is the rule for plans under which the property is sold free and clear of the creditor's lien, and (iii) is a residual provision covering dispositions under all other plans."[75] Accordingly, the Court concluded that "debtors may not sell their property free of liens under § 1129(b)(2)(A) without allowing lienholders to credit-bid, as required by clause (ii)."[76]

The Court briskly rejected the Third Circuit majority's reasoning, under which the word "or" was dispositive, explaining that "[t]he question here is not whether debtors must comply with more than one clause, but rather which one of the three they must satisfy. Debtors seeking to sell their property free of liens under § 1129(b)(2)(A) must satisfy the requirements of clause (ii), not the requirements of *both* clauses (ii) and (iii)."[77]

---

[69] *Id.* at 651-653.

[70] No amici supported the debtor or contended that credit-bidding was poor bankruptcy policy.

[71] *See RadLAX*, 132 S. Ct. at 2073.

[72] *Id.* at 2070.

[73] *Id.* at 2071 (quoting *Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 384 (1992)).

[74] *Id.* at 2071-2072 (quoting *D. Ginsberg & Sons, Inc. v. Popkin*, 285 U.S. 204, 208 (1932)).

[75] *Id.* at 2072.

[76] *Id.*

[77] *Id.*

The Court declined to consider "the purposes of the Bankruptcy Code, pre-Code practices, and the merits of credit-bidding," concluding that the statute contains "no textual ambiguity" and that the analysis thus did not need to proceed beyond the text.[78] It concluded by commenting: "The Bankruptcy Code standardizes an expansive (and sometimes unruly) area of law, and it is our obligation to interpret the Code clearly and predictably using well-established principles of statutory construction. Under that approach, this is an easy case."[79]

V. Is Credit-Bidding Wise Policy?

RadLAX definitively answered the question of statutory construction that the courts of appeals had debated. But it did so on relatively narrow grounds, not addressing the overall structure of the Code's protections for secured creditors or the place of credit-bidding within that structure. And the Court expressly declined to address "the merits of credit-bidding," bypassing any discussion of the policy or purposes of the Code on the ground that the Code's text was clear.[80]

As the Commission considers the overall structure of the Bankruptcy Code and its specific provisions afresh, then, it is worth considering both how credit-bidding fits into the current structure and purposes of the Code and what its costs and benefits are, both to creditors and to the estate. Some commentators have already questioned whether credit-bidding should retain its place in the Bankruptcy Code,[81] and those arguments deserve a response.

A. Credit-Bidding Ensures That The Secured Creditor Receives The Basic Benefit Of Its Bargain

Credit-bidding's role in the larger structure of the Code is addressed, in part, above.[82] As discussed, credit-bidding is part of a carefully crafted, interrelated set of provisions designed to relieve secured creditors, to the extent possible, of the risk of undervaluation of their collateral. It thereby preserves, to the extent possible, secured creditors' fundamental non-bankruptcy right to get either the money owed or the property securing the debt—a property right with constitutional dimensions. Credit-bidding is thus not "frosting"—some extra entitlement conferred by the Bankruptcy Code that can be taken away without disrupting secured creditors' more fundamental rights—but is a necessary mechanism for ensuring that those fundamental rights are respected.

Critics of credit-bidding contend that "secured creditors are entitled to realize the value of their collateral—no more and no less."[83] But that argument begs the very

[78] *Id.* at 2073.

[79] *Id.*

[80] *Id.*

[81] *See supra* note 5.

[82] *See supra* Parts II-III.

[83] Tabb, *supra* note 5, at 39.

question credit-bidding was designed to answer: What *is* the value of a secured creditor's collateral?

The purpose of credit-bidding can be understood only once it is recognized that the "value" of collateral is not a single, objectively ascertainable number, but something that varies over time, and in light of the relevant market, real or hypothetical, for the assets at issue, specific market constraints on the sale of the assets, and transaction and information costs. Ultimately, value is in the eye of the buyer, and where there is no buyer, valuation can typically be no more than an educated guess. In the context of valuing a business that will be sold as a going concern, valuation is particularly uncertain: "There are different methods of valuing a business, but in the end all are merely estimates of the present value of the business's future earning capacity. Founded as they must be on subjective predictions, such valuations come associated with significant uncertainty."[84]

For this reason, while judicial valuation of assets is necessary in many circumstances in bankruptcy, the preference of the drafters of the Code was for market valuation. "In practice, no problem in bankruptcy is more perplexing than the problem of valuation."[85] Accordingly, "one of the Code's innovations [was] to narrow the occasions for courts to make valuation judgments."[86] The Code's preference, instead, is for "decisions ... tested by competitive choice" and reflecting the judgments of the creditors themselves.[87] An auction of assets, if properly conducted, will provide such a decision; and because credit-bidding permits an additional bidder to participate in the process, it can only increase the accuracy of the auction "valuation" process.[88]

Credit-bidding thus does not, and cannot, give secured creditors *more* than the value of their collateral. Rather, credit-bidding enables secured creditors to protect themselves in the event that they are unable to cash bid and their collateral would otherwise be sold for less than it is worth. If the most an outside bidder is willing to pay for the creditor's collateral is $70,000, and the secured creditor is willing to credit-bid $80,000, the value of the collateral is $80,000, and preventing the secured creditor from credit bidding will necessarily mean that it will *not* "realize the value of its collateral."[89]

Put differently, the proceeds of a sale of the creditor's collateral free and clear of its lien that does not permit credit-bidding or otherwise constrains the secured creditor's

---

[84] Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930, 1941-1942 (2006).

[85] *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 466 n.5 (1999) (Stevens, J., dissenting).

[86] *Id.* at 457 (majority).

[87] *Id.* at 457-458.

[88] *See, e.g.*, Buccola & Keller, *supra* note 55, at 119-120; *see also* Resnick, *supra* note 6, at 340 ("[H]ow can [one] know that the bankruptcy court accurately valued the collateral if there was no market test by auction at which the noteholders had a right to credit bid?").

[89] Tabb, *supra* note 5, at 39.

ability to participate can never be the "indubitable equivalent" of the creditor's secured claim. As Professor Baird has put it, the notion that such a sale could provide the indubitable equivalent is "mystifying," "[g]iven that credit-bidding allows the secured creditor to gain control over the asset and any other plan necessarily gives it something less."[90] In Judge Hand's words, the secured creditor is entitled to "his money, or at least the property," or the indubitable equivalent.[91] Because a sale without credit-bidding denies the secured creditor the ability to take the property when it values the property more highly than other bidders, it necessarily falls short of that basic entitlement.

B. The Benefits Of Credit-Bidding To The Estate Outweigh Any Costs

Leaving aside its benefits to secured creditors, credit-bidding provides substantial benefits to the estate. To the extent that credit-bidding permits additional bidders to participate in a sale of estate assets, it serves one of the central aims of the bankruptcy process: "maximizing the value of the bankruptcy estate."[92] And barring credit-bidding risks enabling debtors to steer their businesses to insiders with low-ball bids.

1. Credit-Bidding Maximizes The Value Of The Estate

Credit-bidding benefits the bankruptcy estate for several reasons.

Increasing the number of bidders. First, and most fundamentally, credit-bidding increases the potential number of bidders at the auction and thus increases the potential value the auction can realize. Basic auction theory, and common sense, make clear that the winning bid at an auction reflects what the highest and next-highest bidders are willing to pay. Adding more bidders can thus only increase the winning bid, and excluding a bidder can only decrease it.[93]

To be concrete, imagine a very simple auction with three bidders, Stalking Horse, Outsider, and Secured Creditor. Secured Creditor is owed $100,000, secured by the assets to be auctioned. Stalking Horse has announced an initial bid of $60,000, but is privately willing to pay $90,000. Outsider is willing to pay $70,000, and Secured Creditor is willing to pay $80,000, but only if it can credit-bid. Imagine bidding occurs in $1,000 increments. If Secured Creditor is excluded from the auction by a bar on credit-bidding, the auction will realize $71,000—the least that Stalking Horse will have to bid to beat Outsider. But if Secured Creditor is permitted to bid, the auction will realize $81,000. If the positions of Secured Creditor and Stalking Horse are reversed, so that Secured Creditor is the highest bidder, the result will be the same—the auction will realize $10,000 more with Secured Creditor than without it. If Secured Creditor values the collateral the lowest of the three bidders, its presence will have no effect on the

[90] Douglas G. Baird, *Car Trouble* 16 (U. Chi. John M. Olin Law & Econ. Working Paper Series) (May 2011), *available at* ssrn.com/abstract=1833731.

[91] 75 F.2d at 942.

[92] *Toibb v. Radloff*, 501 U.S. 157, 163 (1991).

[93] *See* Buccola & Keller, *supra* note 55, at 117-119; Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 Stan. L. Rev. 70, 109-110 (1991).

auction proceeds. In each scenario, the estate is better off, or at least as well off, if credit-bidding is allowed.

One objection that has been raised to this scenario is that the presence of a secured creditor bidding with credit rather than cash will "chill" cash bidders. The purported chilling effect is ascribed to various factors. One variant of the argument posits that outside bidders will be deterred by the assumption that a secured creditor has superior information regarding the value of the assets, and that if they outbid the secured creditor they will thus have paid too much—the so-called "winner's curse."[94] As one commentator acknowledges, if true, this phenomenon is not specific to credit-bidding, but could also apply to secured creditors bidding with cash.[95] Indeed, it is not specific to secured creditors either, but could also be true of stalking-horse bidders, which almost by definition have superior information regarding the assets due to the diligence conducted in formulating the stalking-horse bid.[96] Information asymmetries do tend to lead to less efficient outcomes. But the answer to this problem is not to exclude stalking-horse bidders, or secured creditors, or informed bidders generally, but to take steps to ensure that the marketing process for the assets is robust and that potential bidders have as much information, and as much opportunity to conduct diligence, as is possible consistent with an efficient auction process. Moreover, to the extent that the chilling effect exists, that is all the more reason to allow secured creditors to compete with a stalking-horse bidder, since secured creditors share the stalking-horse bidder's informational advantage and thus should not be deterred by the prospect of the winner's curse.

A slightly different twist on the "chilling" argument posits that secured creditors have different bidding incentives than other bidders. As long as bids are lower than the amount of its claim, the argument goes, the secured creditor is more like a seller than a buyer: It will bid up the price of the assets not because it wants to buy them for that price, but because it will receive the proceeds of the auction and thus wants the price paid by the winning bidder to be as high as possible.[97] At first blush, this seems like a good thing, not a bad thing, from the estate's point of view: The estate also wants the price paid by the winning bidder to be as high as possible. But, the argument is, outside bidders who know that secured creditors have this incentive are less likely to participate in the auction because they know that the secured creditor may drive up the price beyond what the secured creditor privately believes the assets to be worth.[98]

To the extent that the argument here is that cash bidders will be chilled because they fear that a secured creditor may outbid them, it lacks force. That would be equally true of any deep-pocketed bidder,[99] and no auction can afford to exclude the bidders with

---

[94] *See* Kling, *supra* note 5, at 280; Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. Chi. L. Rev. 759, 788 n.121 (2011).

[95] *See* Kling, *supra* note 5, at 280.

[96] *See* Casey, *supra* note 94, at 787-788.

[97] *See* Kling, *supra* note 5, at 281-283.

[98] *See id.*

[99] *See, e.g.,* Buccola & Keller, *supra* note 55, at 123.

the greatest resources on the ground that they might outbid everyone else. Nor can it afford to do so based on the mere possibility that some other hypothetical bidder might exist who would have shown up and paid more for the assets were it not for the presence of the deep-pocketed bidder. To the extent that the argument is, again, that secured creditors enjoy the benefit of information asymmetry, the answer is, again, that sale procedures should be designed to minimize such asymmetry, not that the best-informed bidders should be excluded.

In any event, the premise of this argument seems questionable. A secured creditor who bids up the price of its collateral not because it wants the collateral itself, but because it wants to maximize the cash it will receive from the winning bidder, would be playing a risky game of chicken. Once the bidding rises above the amount at which the secured creditor values the assets, the creditor risks losing the cash it would otherwise have obtained and getting stuck instead with unwanted assets that it will presumably then have to sell.[100] Assuming the creditor has valued the assets accurately, and taking transaction costs into account, that would be a losing proposition. Presumably other bidders will know all this and thus will not be unduly deterred by the secured creditor's ability to bid.

The secured creditor's particular position. As noted above, the secured creditor is not just any bidder. And the secured creditor's informational advantage and its particular incentives—the very factors that some argue chill other bidders—could equally well be perceived as benefiting the estate. Because the secured lender is likely to have good information about the value of the asset, it is less likely to discount its bid on account of the "lemons" effect,[101] and more likely to bid confidently at higher prices. Moreover, the secured creditor has an incentive shared by no other bidder to defeat low-ball bids on its collateral, whether they result from inadequate marketing of the assets or from management's attempts to steer the business to a favored buyer. "Credit-bidding affords them a ready tool to effectively act on that incentive."[102]

Transaction costs associated with cash bidding. Finally, permitting credit-bidding minimizes the substantial costs associated with preparing and financing a cash bid. And because the bidder who can avoid the additional costs attendant on a cash bid can offer that much more for the asset, permitting credit-bidding thus maximizes what the secured creditor can afford to pay. Forcing the secured lender to pay in cash simply imposes a tax on the lender and means that the estate realizes less on the sale.[103]

Cash bidding cannot substitute for credit-bidding for several practical reasons. As an initial matter, few entities have the necessary cash on hand to purchase the kinds of

---

[100] *See, e.g., id.* ("By bidding a particular sum on credit, the secured creditors are eschewing the cash they would otherwise receive for any cash offer beneath their bid.").

[101] *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. Econ. 488 (1970).

[102] Buccola & Keller, *supra* note 55, at 120.

[103] *See id.* at 121.

assets typically at issue in commercial bankruptcies. Creditors will thus incur interest payments and fees to investment bankers, lawyers, and others who may be necessary to structure such transactions. Moreover, although the creditor will ultimately receive its cash back if its cash bid wins the auction, the cash does not come back immediately: typically, it flows into the estate and the creditor obtains a lien on the cash, which is then distributed under the plan.[104] These out-of-pocket expenses and time-value losses ultimately reduce the amount the secured creditor can bid and, if the secured creditor wins the collateral, reduce the estate's recovery. And that is assuming that credit will be available to finance a cash bid. If credit markets are frozen, bidding will be impossible for all but the most cash-flush bidders.

Moreover, some secured creditors will not be able to bid at all if prevented from credit-bidding. Modern commercial financings typically involve syndicates of secured lenders or groups of secured bondholders, which complicates the tendering of cash bids on their collective behalf.[105] And some of today's most common commercial creditors operate under legal restrictions that prevent them from making cash bids. More and more loans are held by mutual funds or CLOs whose operations are governed by indentures restricting the uses that can be made of available cash. These indentures may not allow such creditors to use or borrow cash to purchase property, even if the cash will ultimately be returned to the buyer. In addition, as the *RadLAX* Court noted, the federal government may also lack authority to make a cash bid: The right to credit-bid "is particularly important for the Federal Government, which is frequently a secured creditor and which often lacks appropriations authority to throw good money after bad in a cash-only bankruptcy auction."[106]

* * *

Ultimately, then, preventing secured creditors from credit-bidding will almost certainly reduce the value of the bankruptcy estate. In this regard, a dollar of credit should be viewed as equivalent to a dollar in cash. If a secured creditor wins its collateral by bidding $80,000 of its $100,000 claim, the estate's liabilities are reduced by $80,000. If a stalking-horse bidder pays $80,000 for the collateral, the proceeds go to the secured creditor, and the estate's liabilities are again reduced by $80,000. There can be no difference from the estate's point of view. And if the secured creditor bids the full $100,000 of its claim because doing so is purportedly costless to the creditor, that is all the better for the estate. In short, "keeping a credit bidder from participating in a bankruptcy auction is an unsupportable strategy, at least for a debtor intent on maximizing its sale proceeds."[107]

[104] *See* 11 U.S.C. § 1129(b)(2)(A)(ii).

[105] *See* Erens & Hall, *supra* note 55, at 563-564.

[106] 132 S. Ct. at 2070 n.2.

[107] Buccola & Keller, *supra* note 55, at 119-120.

2. Preventing Credit-Bidding Facilitates Debtor Self-Dealing

While most debtors-in-possession are indeed attempting to maximize sale proceeds, some are pursuing other, more parochial objectives, and for that minority barring credit-bidding may well be a useful strategy.

In that regard, *Philadelphia News* is a cautionary tale. As discussed above, the debtors in *Philadelphia News* operated two daily Philadelphia newspapers, purchased with a loan from a consortium of lenders. Debtors defaulted on the loan and filed for bankruptcy, at which point the prepetition lenders were owed about $318 million, secured by substantially all the debtor's assets. Debtors filed a chapter 11 plan providing that their assets would be sold free and clear of the lenders' liens, and simultaneously entered into an asset purchase agreement with a stalking-horse bidder, Philly Papers LLC. The majority owners of Philly Papers were major equity-holders, or persons who were equity-holders until the day before the asset purchase agreement was signed, in the debtors. The plan proposed to give the lenders about $37 million in cash and the debtors' Philadelphia headquarters, valued at around $30 million, subject to a two-year rent-free lease to the new owner. Debtors sought to preclude the lenders from credit-bidding at the sale of their collateral.[108]

In his dissent, Judge Ambro commented on the facts of the case:

> The debtors seek to sell their assets free of liens and to stop their secured lenders from bidding at sale up to the full credit they have extended. To understand why, we need to know the backstory. ...
>
> As part of a high-stakes game of chicken, the debtors have engaged in an extensive advertising campaign related to the proposed auction that promotes the message "Keep it Local." This is apparently a reference that the Stalking Horse Bidder—largely composed of and controlled by the debtors' current and former management and equityholders—is the favored suitor. Perhaps the most striking example of the type of game the debtors are playing is the two-years of *free rent* on the building to be leased to the Stalking Horse Bidder, while ostensibly "surrendering" the building to the secured lenders.
>
> The Stalking Horse Bidder is seeking to pay as little as possible to obtain the assets "on the cheap[.]" ... If credit bidding is denied, … the debtors' insiders stand to benefit by having more leverage to steer the sale to a favored purchaser (here, the Stalking Horse Bidder).[109]

Although the Third Circuit agreed with the debtors that credit-bidding was not required in a sale under a plan, the debtors' tactics were frustrated when the group of lenders was able to coordinate sufficiently quickly to place a cash bid, which won the auction. Had the lenders been unable to accomplish that, however—and, as described

[108] *See Philadelphia News*, 599 F.3d at 301-302.

[109] *Id.* at 319-320 (Ambro, J., dissenting).

above, there are significant obstacles to cash bidding for syndicates of lenders—debtors' current management would have been able to manipulate the auction so that the assets were purchased at a low-ball price by favored bidders with insider connections, to the detriment of the estate and its creditors.

Although the facts of *Philadelphia News* were egregious, they are not unique. *RadLAX*, for instance, arose on similar facts, with an initial bid submitted by a stalking-horse bidder with ties to existing management. In general, bankruptcy proceedings present a principal-agent problem, in which the incentives of the debtor's owners and existing management are unlikely to accord with those of the creditors whose interests the debtor-in-possession has a duty to protect. Present management may have an incentive to favor bidders who will preserve management's own positions, for instance, even if their bid is not otherwise the highest and best offer.[110]

Most managers in chapter 11 surely take their fiduciary responsibilities seriously. Moreover, many respected scholars agree that, over the last twenty years, the balance of power in chapter 11 cases has shifted away from the debtor-in-possession and toward secured creditors, due to the changing capital structure of firms entering bankruptcy (itself due to changes in the market for credit).[111] And it may be that, as a result, the principal-agent problem described above is less troublesome now than formerly, because secured creditors tend to exercise more control over the corporate governance of the debtor. Nonetheless, as *Philadelphia News* and *RadLAX* show, permitting debtors' management to bar secured creditors from credit-bidding at a sale of their collateral is an invitation to self-dealing, with no countervailing benefits for the estate. Changes in the overall dynamic of chapter 11 cases do not alter that conclusion.

C. Proposals To Eliminate The Right To Credit-Bid Are Flawed

Two commentators (that I know of) have recently proposed that the right to credit-bid should be eliminated or restricted. They offer different reasons in each case, but both proposals are ill-advised.

First, in a recent article, Jacob Kling has argued that while Section 363 sales are often the most economically efficient mechanism for realizing value in chapter 11, certain attributes of such sales, including credit-bidding, can render sales less efficient and should be revised or eliminated.[112] Specifically, he contends that credit-bidding will

[110] *See, e.g.*, Buccola & Keller, *supra* note 55, at 120 ("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.").

[111] *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, *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., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. Pa. L. Rev. 917 (2003).

[112] Much of Kling's article addresses other aspects of Section 363 sales, including potential violations of absolute priority, which are outside the scope of this submission.

chill cash bidders, depressing auction prices, and that the protections it offers secured creditors are no longer necessary.[113] I have already responded to Kling's arguments that credit-bidding will chill cash bidders above: In short, I believe that any "chill" that may exist is likely exaggerated, can better be addressed by sale procedures that reduce information asymmetry, and provides no justification for excluding from an auction a party that has a very substantial likelihood of being the highest or next-highest bidder and thus increasing the auction returns.[114]

Kling prefaces his argument that credit-bidding is not necessary by acknowledging that credit-bidding is intended to protect secured creditors from undervaluation in the sale context, just as Section 1111(b)—which he apparently would retain—protects secured creditors from undervaluation when the debtor will retain the collateral under its plan.[115] But, he contends, "the threat of an erroneously low judicial valuation of the collateral is not present in a 363 sale, where the market determines the value of the property."[116] Moreover, "[s]ince secured creditors are frequently the leading proponents of 363 sales, there seems to be little need to protect them against a sale at an inadequate price by allowing them to bid for the collateral themselves."[117]

The logic of these assertions is not entirely clear. To be sure, there is no risk of *judicial* undervaluation in a Section 363 (or other) sale of collateral. But it does not follow that there is no risk of undervaluation. To the contrary, every time a secured creditor is excluded from bidding but would have bought the collateral had it been permitted to credit-bid, by definition the collateral has been undervalued. Kling appears not to recognize this risk of undervaluation because he views credit bids above the creditor's "private value" for the asset as *over*valuing the asset—"driv[ing] the price of the assets above their true value."[118] Leaving aside the point that creditors are not likely to bid well above their own "private value" for the assets, since in doing so they forgo the cash they would otherwise receive from the next-highest bidder, from the perspective of value maximization this seems skewed. The "true value" of the collateral to the estate, and to the creditor that holds a lien on it, is whatever the highest bidder—including the creditor itself—will pay. But when the highest bidder is excluded on the ground that it might pay *more* than the asset is worth, that value cannot be realized.

Professor Charles Tabb has argued, in a slightly different vein, that, while the 1978 Code was designed to protect secured creditors against undervaluation, in part through credit-bidding, credit-bidding is now "obsolete."[119] Tabb contends, in an account that echoes many others, that when the Code was enacted, the debtor was largely in

---

[113] *See* Kling, *supra* note 5, at 260-261.

[114] *See supra* Part V.B.1.

[115] *See* Kling, *supra* note 5, at 278.

[116] *Id.*

[117] *Id.* at 279.

[118] *Id.* at 281.

[119] *See* Tabb, *supra* note 5.

charge of its own destiny and secured creditors were “effectively dispossessed and declawed” by routine extensions of exclusivity, frequent violations of absolute priority, the imposition of the automatic stay, denial of postpetition interest except to oversecured creditors, and the prospect of having their liens primed by a DIP lender.[120] “To counter [the] distortions” of efficiency and fairness produced by that dynamic, “it was an understandable and defensible counterbalance for the Bankruptcy Code to afford powerful collateral value realization protections to secured creditors.”[121]

While many of the features of chapter 11 Tabb identifies, of course, still exist, he depicts a world that is profoundly different from what it used to be. “Today, senior secured debt rules. ... 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.”[122] In this world, he contends, “the core presumption that motivated” the Code’s protections for secured creditors—“of disenfranchised helplessness in need of paternalistic protection”—no longer obtains.[123] “Far from being a floor safeguard for disempowered secured lenders, credit bidding is often 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*.”[124] Based on this narrative, Tabb draws the conclusion that the presumption in favor of credit-bidding should be reversed, and that secured creditors should be required to show cause before being permitted to credit-bid.[125] He concludes: “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.... [T]he 1978 Bankruptcy Code balancing act has become obsolete. The time has come to restore the balance.”[126]

There are at least two difficulties with this line of reasoning. First, although much of Tabb’s account of the changes in chapter 11 dynamics since 1978 echoes the accounts of other scholars and observers, his description of what drove Congress to provide secured creditors with the right to credit-bid seems somewhat distorted. There is no reason to believe that Congress gave secured lenders the right to credit-bid because it felt they were “disenfranchised,” “helpless,” and “in need of paternalistic protection”—strange phrases to apply to banks that knowingly entered into commercial dealings with the debtor, even in 1978. When Congress drafted the Code—as Tabb’s own account earlier in his article demonstrates[127]—the task it undertook was not to provide

[120] *Id.* at 31.

[121] *Id.* at 32.

[122] *Id.*

[123] *Id.* at 33.

[124] *Id.*

[125] *See id.* at 34.

[126] *Id.* at 39.

[127] *See id.* at 15-19.

paternalistic protection for victimized banks. Nor was it a "balancing act" undertaken to create a level playing field for negotiations between debtor and creditors by piling some rights onto the debtor's side of the field and some rights onto the creditors' side.

Rather, Congress began with the presumption that bankruptcy law preserves state-law rights except where an important federal purpose requires otherwise.[128] Accordingly, it built a structure that carefully preserved a secured creditor's fundamental right to get either its money or its collateral, while modifying certain other rights when that was necessary for reorganization to be possible—e.g., the right to control the timing of foreclosure[129] and the right to be paid on the same schedule as the loan documents provided.[130] As discussed above, the right to credit-bid was an integral part of that structure, ensuring that if collateral was sold, the creditor could obtain it if it valued it more highly than other potential purchasers. Credit-bidding simply ensured that secured creditors could not be cashed out at less than the full value of their collateral, but would receive the basic benefit of the bargain they made outside bankruptcy. It was not an "extra" right given to secured creditors to counterbalance overreaching debtors.

Second, and as already discussed above,[131] Tabb's argument appears to be based on the false premise that credit-bidding somehow gives creditors *more* than "the value of their collateral." To the contrary, if we are to preserve the fundamental principle "that secured creditors are entitled to realize the value of their collateral," we must keep credit-bidding, not discard it.

None of this is to say that the increasing prevalence of secured credit and the shifting dynamics of chapter 11 described in Tabb's article are insignificant, or that they do not merit a legislative response. The effect of the new credit markets on chapter 11—and vice versa—raises serious and difficult questions that richly deserve the study the Commission is giving them. For instance, Tabb's article touches on a concern also raised by Professor Klee at the October 26, 2012 hearing before the Commission: whether secured creditors may recover a greater percentage of their claims when their collateral is sold through chapter 11 than when they use state-law foreclosure remedies. Professor Klee asked whether, if so, that chapter 11 "surplus" should be shared in some form with junior stakeholders. Such a proposal raises fundamental and non-obvious questions about the nature of a secured creditor's interest in its collateral, as well as important policy questions regarding distributional priorities in bankruptcy, and warrants further examination. By contrast, eliminating credit-bidding bears no obvious relationship to the concerns Tabb and others have raised. Taking away the right to credit-bid on the ground that secured creditors have too much power would do nothing more than reduce the estate's recoveries and make it easier to transfer businesses in chapter 11 to buyers preferred by existing management, rather than buyers who value them most highly and will put them to their highest and best use.

---

[128] *See Butner v. United States*, 440 U.S. 48, 54-55 (1979).

[129] *See* 11 U.S.C. § 362.

[130] *See id.* § 1129(b)(2)(A)(i).

[131] *See supra* Part V.A.

*   *   *

Again, I thank the Commission for giving me the opportunity to testify today, and I am happy to answer any questions the Commission may have.