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Supreme Court Protects Credit Bid in Hotel Bankruptcy

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How Does *RadLAX* Impact Conventional Chapter 11 Plan Structures?

On May 29, 2012, the United States Supreme Court held in *RadLAX Gateway Hotel LLC v. Amalgamated Bank* ("*RadLAX*"), that a debtor-owner of a hotel encumbered by a mortgage lien securing over $120 million, could not obtain confirmation of a chapter 11 plan proposing to sell the hotel free of the lien to a stalking horse bidder offering $55 million cash, or to any bidder offering more, unless the mortgagee were allowed to credit bid up to its full claim. Justice Scalia called it "an easy case" of statutory construction of Bankruptcy Code section 1129(b)(2)(A). What are the implications of the ruling?

1. What if the chapter 11 plan provides for the mortgagee to be paid the judicially determined value of the hotel, say $70 million raised from a new mortgage loan and creditor contributions under a rights offering, with the unsecured claimholders (including the mortgagee's $50 million deficiency claim) and participants in the rights offering to receive their pro rata shares of 100% of the equity in the reorganized debtor? Is that a sale of the debtor's assets entitling the mortgagee to credit bid?

This hypothetical substantively amounts to a sale of the hotel, free of the mortgage lien, to creditors. *RadLAX* may appear to allow the mortgagee to credit bid up to $120 million. But, based on *RadLAX*'s reasoning that the specific statutory provision overrules the general provision, and the sequencing of the provisions matters, it is certainly plausible that Bankruptcy Code section 1129(b)(2)(A)(i) would control. It allows for the mortgagee to be crammed down with a secured note in the amount of the value of the collateral. Certainly, the creditor cannot complain that cash is substituted for the note, or that the note is a one-day note as the court posited in *Bank of New York Trust Co. v. Official Unsecured Creditors' Committee (In re Pacific Lumber Co.)*, 584 F.3d 229, 247 (5th Cir. 2009). The issue here is whether the traditional conversion of debt into equity through a plan should be construed as a sale free and clear of liens, subject to credit bidding pursuant to Bankruptcy Code sections 1129(b)(2)(A)(ii), or 103(a) and 363(k).

2. What if the chapter 11 plan provides for the mortgagee to be paid the judicially determined value of the hotel, say $70 million raised from a third party? Is the secured lender entitled to credit bid?

This was the hypothetical posed by the Fifth Circuit in *Bank of New York Trust Co. v. Official Unsecured Creditors' Committee (In re Pacific Lumber Co.), 584 F.3d 229 (5th Cir. 2009)*. The Fifth Circuit reasoned that once the value of a secured lender's collateral has been judicially determined, section 1129(b)(2)(A)(i) can be satisfied by issuance of a "one-day note." The Fifth Circuit noted that: "[w]hatever uncertainties exist about indubitable equivalent, paying off secured creditors in cash can hardly be improper if the plan accurately reflected the value of the [secured creditors'] collateral." 584 F.3d at 247. That said, the Supreme Court has expressed a preference for market testing the value of collateral over judicially determining its value for purposes of determining whether the debtor's owners are contributing sufficient new value to reacquire ownership of the real property. *Bank of America v. 203 North LaSalle Street Partnership*, 119 S. Ct. 1411, 1424 (1999).

3. If an investor buys a secured claim during the chapter 11 case with the intent of using its rights to credit bid to acquire ownership of the estate's assets, should the investor's vote on the plan be designated (i.e., not counted) because the investor bought the claim to obtain control?

The fact that an investor buys a claim hoping to credit bid would not appear, by itself, to constitute an "ulterior motive" sufficient for designation. Indeed, credit bidding is a statutorily prescribed creditor's right under certain circumstances so the intent to credit bid should not be interpreted as "an interest other than an interest as a creditor." In *Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.), 634 F.3d 79 (2d Cir. 2011)*, the Second Circuit was clear that "selfishness alone [does not] defeat a creditor's good faith; the [Bankruptcy] Code presumes that parties will act in their own self interest and allows them to do so." 634 F.3d at 102. Consequently, the motives of an investor who buys a claim hoping to credit bid would not appear to rise to the necessary level for a bankruptcy court to designate the investor's vote. Of course, if it is discovered that the investor in fact has "ulterior motives" other than making an investment and exercising a right to credit bid, the outcome to this hypothetical may be radically different depending on whether the motive requires disparate treatment of claims in the same class, or involves blackmail and the like.

A Caveat

To try to avoid the treatments of the secured claims in these hypotheticals, some lenders may attempt elections under Bankruptcy Code section 1111(b)(2) to provide them with new notes in the full amounts of their secured and unsecured claims. These elections, however, can backfire when the plan proponent invokes a strategy as in *Airadigm Communications, Inc. v. Federal Communications Commission (In re Airadigm Communications, Inc.)*, 519 F.3d 640 (7th Cir. 2008), whereby the proponent substitutes for the original collateral an amount of 30-year U.S. treasury bills having an aggregate principal amount equal to the value of the collateral, and whose interest payments over 30 years will aggregate the full amount of the creditor's deficiency claim.

Conclusion

The United States Supreme Court's decision in *RadLAX* resolves the uncertainty created by the circuit split regarding the right to credit bid a secured claim under a plan sale. The next frontier will be determining what facts constitute a plan sale.

Related Professionals

- **Justin Breen**
  Partner
- **Gary J. Creem**
  Partner
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  Partner
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