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Secured Creditors Secure Win

Supreme Court Upholds Credit Bidding Rights

By Alan Lepene, Andrew L. Turscak, Jr., and James Henderson

In a major victory for secured creditors, the United States Supreme Court unanimously held that a Chapter 11 plan involving a sale of secured property free and clear of a creditor's lien must afford the secured creditor the right to credit bid for the property under section 363(k) of title 11 of the United States Code (the Bankruptcy Code). *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. __ (2012). In so holding, the Court resolved the split that had emerged among the United States Circuit Courts of Appeals, as illustrated by the Seventh Circuit's decision below (*River Road Hotel Partners, LLC v. Amalgamated Bank*, 651 F.3d 642 (7th Cir. 2011)), which contrasted with other recent decisions from the Third and Fifth Circuits, respectively.

Unlike the Seventh Circuit, the Third and Fifth Circuits had held that a plan eliminating the credit bid rights of a secured creditor could be approved over the objection of the secured creditor, as long as that creditor was provided with the indubitable equivalent of its secured claim by some other means. *See In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010); and *In re Pacific Lumber Co.*, 584 F.3d 229 (5th. Cir. 2009).

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TOUSA Case Takes Another Twist

Eleventh Circuit Reverses District Court Ruling

By Ted A. Berkowitz and Veronique A. Urban

The closely watched TOUSA, Inc. case took another twist on May 15, when the Eleventh Circuit Court of Appeals (the Court of Appeals) reversed the decision of the United States District Court for the Southern District of Florida (the District Court) and reinstated the bankruptcy court opinion in its entirety. *Senior Transeastern Lenders v. Official Comm. Of Unsecured Creditors of TOUSA, Inc.*, No. 11-1107, 2012 WL 1673910 (11th Cir. May 15, 2012). In doing so, the Court of Appeals affirmed the bankruptcy court's ruling that transfers made by certain subsidiaries of TOUSA, Inc. (the Conveying Subsidiaries) were fraudulent and paved the way for the possible disgorgement of $403 million by the lenders that were on the receiving end of those fraudulent transfers. The decision reinforces the level of diligence and care that lenders must undertake in cases involving borrower subsidiaries, especially with respect to upstream loan transactions.

Factual Background

The facts of this case date back to June 2005, when Tousa Homes LP (Tousa Homes), a wholly owned subsidiary of TOUSA, Inc. (TOUSA), announced plans to acquire one of its competitors, Transeastern Properties, Inc. The acquisition was structured as a joint venture between Tousa Homes and Falcone/Ritchie LLC (Transeastern JV). In order to fund the acquisition, the Transeastern JV entered into three credit facilities with various lenders (the Transeastern Lenders), aggregating approximately $675 million. While TOUSA and Tousa Homes guaranteed the obligations under the credit facilities, none of the Conveying Subsidiaries had any obligations under the Transeastern credit facilities.

In September 2006, following the Transeastern acquisition, the Florida housing market rapidly declined, causing the Transeastern JV to default under its credit facilities with the Transeastern Lenders. As a result, the Transeastern Lenders sued TOUSA and Tousa Homes in New York State court for the breach of their guarantees under the credit facilities. TOUSA and Tousa Homes settled the litigation with

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the Transeastern Lenders for approximately $421 million, among other reasons, to avoid having an adverse judgment filed against TOUSA in excess of $10 million, which would have triggered a cross-default under certain of its bond indentures and a revolving credit facility for which the Conveying Subsidiaries served as guarantors.

In July 2007, in order in part to fund the settlement with the Transeastern Lenders, TOUSA entered into new secured credit facilities with various lenders (the New Lenders), aggregating approximately $476 million. As a condition for obtaining the new loans, the Conveying Subsidiaries pledged their assets as collateral for the new loans even though they were not a party to the litigation and were not going to receive any of the new loan proceeds. The New Lenders transferred the proceeds of the new loans to Universal Land Title, Inc. (ULT), a TOUSA subsidiary, which in turn immediately transferred approximately $426 million of the new loan proceeds to the Transeastern Lenders as expressly directed in the new loan documentation.

On Jan. 29, 2008, TOUSA, Tousa Homes and the Conveying Subsidiaries, among other TOUSA affiliates, filed for relief (the TOUSA Bankruptcy Cases) under Chapter 11 of the United States Code (the Bankruptcy Code) in the United States Bankruptcy Court for the Southern District of Florida (the Bankruptcy Court).

Committee Commences Adversary Proceeding

On July 14, 2008, the Official Committee of Unsecured Creditors in the TOUSA Bankruptcy Cases (the Committee) filed an adversary proceeding in which it sought, in relevant part, to: 1) avoid, under §§ 544 and 548 of the Bankruptcy Code, the lien transfers made by the Conveying Subsidiaries to the New Lenders; 2) avoid, under §§ 544 and 548 of the Bankruptcy Code, the transfer of the new loan proceeds from ULT to the Transeastern Lenders; and 3) recover the value of the lien transfers and the proceeds transfer from the Transeastern Lenders under § 550 of the Bankruptcy Code on the basis that the Transeastern Lenders were the direct transferees of the proceeds of the new loans and were entities for whose benefit the liens were transferred by the Conveying Subsidiaries.

Sections 544 and 548 of the Bankruptcy Code allow a trustee to avoid a transfer of "an interest of the debtor in property" or "obligation incurred by the debtor" that was: 1) made for "less than reasonably equivalent value"; and 2) made while the debtor was insolvent or had unreasonably small capital at the time of the transaction or as a result of the transaction. 11 U.S.C. § 548. In its Complaint, the Committee argued that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for either the transfer of their liens or the proceeds transfer. In addition, the Committee alleged that, as a result of the transfers, the Conveying Subsidiaries were either insolvent or rendered insolvent, left with unreasonably small capital or became unable to pay their debts as they were to come due.

Section 550(a)(1) of the Bankruptcy Code allows a trustee to recover an avoided transfer from: 1) the initial transferee; 2) the entity for whose benefit such transfer was made; or 3) a subsequent transferee. 11 U.S.C. § 550(a)(1). In this case, the loan proceeds were received by ULT, but as required under the documentation, were immediate transferred to the Transeastern Lenders. In addition, although the lien transfers were made by the Conveying Subsidiaries to the

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In re Grumman

S.D.N.Y. Limits Scope of § 363 Sale Against Successor Liability Claims

By Jeff J. Friedman and James N. Truitt

A recent decision by the United States District Court for the Southern District of New York explores the tension between the duty to maximize the value of the estate in bankruptcy and the due process rights afforded to future claimants in the context of a sale under § 363 of the Bankruptcy Code. In *Morgan Olson L.L.C. v. Frederico* (*In re Grumman Olson Indus., Inc.*), 2012 WL 1038672 (S.D.N.Y. March 29, 2012), the U.S. District Court affirmed the bankruptcy court's ruling that a § 363 sale order purporting to extinguish all claims for successor liability could not be enforced to enjoin a state law successor liability claim brought by claimants who, at the time of the sale, had not yet been injured and who had no way of knowing that such claims would arise. By limiting the reach of the § 363 sale order, the court held the due process rights of future claimants outweighed the benefit to the bankruptcy estate and potential increase in value that a more broadly read § 363 sale order might confer.

Asset Sales Pursuant to Section 363

Section 363(b) of the Bankruptcy Code provides a debtor-in-possession or trustee with the power to sell property of a debtor's estate outside the ordinary course of business, and in conjunction with § 363(f), "free and clear of any interest" in property subject to the sale. A § 363 sale frequently plays a critical role in a liquidation or reorganization, as it provides a debtor-in-possession or trustee with the ability to dispose of property in a manner that may increase the value of such property by extending "free and clear" protections to third party purchasers. Although § 363 sales are widely used, courts continue to struggle with the applicability of the "free and clear of any interest" language of § 363(f), especially as it applies against future claims, including future successor liability claims against a purchaser.

In applying § 363(f), courts have differed in their approach to the interpretation of what constitutes an "interest in property." The phrase is not defined in the Bankruptcy Code, nor does the relevant legislative history provide helpful guidance as to how broadly a court should construe the word "interest." Given this lack of clarity, a minority of courts have declined to extend "interest in property" beyond in rem interests, such as preexisting security interests and other liens attaching to the sale property, which are then extinguished pursuant to the § 363 sale order, with liens attaching to the proceeds of sale. A majority of courts more broadly apply "interest in property" to include *in personam* interests, such as certain tort claims, including product liability claims arising against a debtor or that could be asserted against a purchaser under a state law successor liability doctrine.

Yet, even where courts agree that § 363(f) should be broadly construed to include successor liability claims generally, problems arise where such claims are based upon certain tort actions that implicate an overriding federal interest (*i.e.*, environmental claims), or where, as in *Grumman*, the potential successor liability arose well after the closing of the § 363 sale, the so-called "future claim." Indeed, these future claims challenge courts, such as the court in *Grumman*, to clarify whether: 1) a "future claim" constitutes an "interest in property" pursuant to § 363(f); and 2) conventional notice provisions can satisfy the due process rights of a future claimant.

In re Grumman Olson Industries, Inc.

On Dec. 9, 2002, Grumman Olson Industries, Inc. (the Debtor) filed for Chapter 11 relief in the United States Bankruptcy Court for the Southern District of New York. The Debtor was an automotive manufacturer, specializing in the design and manufacture of truck body parts. On July 1, 2003, the bankruptcy court issued a sale order pursuant to § 363 approving the sale of certain of the Debtor's assets to MS Truck Body Corp., a predecessor in interest of Morgan Olson, LLC (Buyer). Pursuant to the sale order, the property was purchased by the Buyer free and clear of all claims and other interests, "including but not limited to, claims for successor or vicarious liability." *Morgan Olson, LLC v. Frederico* (*In re Grumman Olson Indus., Inc.*), 445 B.R. 243 at 246 (Bankr. S.D.N.Y. 2011).

In October 2009, several years after the sale was completed, Denise and John Frederico (the Claimants) commenced a personal injury action against the Buyer in New Jersey Superior Court. According to the Claimants, Ms. Frederico, a FedEx employee, sustained serious injuries in October 2008 when the FedEx truck she was operating hit a telephone pole. The Claimants alleged, *inter alia*, that the FedEx truck involved in the accident was manufactured, designed and/or sold by Grumman in 1994, and was defective, and that the Buyer was liable for the injuries sustained by Ms. Frederico under New Jersey's successor liability law.

In March 2010, the Buyer initiated an adversary proceeding in the bankruptcy court seeking declaratory and injunctive relief against the Claimants. It its brief, the Buyer argued that the bankruptcy court's sale order exonerated the Buyer from any liability, including successor liability. Both parties then moved for summary judgment.

Bankruptcy Court Decision

Judge Bernstein issued the bankruptcy court's ruling on Feb. 25, 2011. After first confirming that the court retained subject matter jurisdiction over the proceeding because the dispute turned in part on an interpretation of the court's sale order, the court then turned to the conflict over

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Successor Liability

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the future claim, finding that: 1) interests in property include "claims" arising from assets that were sold, and that the Claimants, having had no contact with Grumman prior to the accident, did not hold a "claim" at the time of the sale order; and 2) the sale notice procedures did not satisfy the Claimants due process rights. Accordingly the Claimants could not be enjoined from bringing the successor liability claims against the Buyer.

Notably, the court likened the facts in *Grumman* to a hypothetical posed by the Second Circuit in *United States v. LTV Corp.* (*In re Chateaugay Corp.*), 944 F.2d 997, 1003 (2d Cir. 1991). In *Chateaugay*, the Second Circuit explored a fictional fact pattern in which it was a certainty that one in 10,000 bridges built by a manufacturer would fail, and that each such failure would result in 10 fatalities. Thus, although a court could find with a reasonable degree of certainty that the bridge manufacturer would be responsible for a certain number of fatalities, it would be impossible for a court to identify specific (and exceedingly unlucky) victims before they are harmed by the bridge failure. Accordingly, under the Second Circuit's test, a contingent or unmatured obligation is a "claim" if the occurrence of the contingency or future event that would trigger liability was "'within the actual or presumed contemplation of the parties at the time the original relationship between the parties was created.'" *Chateaugay*, 944 F.2d at 1004 (q*uoting In re All Media Props., Inc.*, 5 B.R. 126, 133 (Bankr. S.D. Tex. 1980), aff'd mem., 646 F.2d 193 (5th Cir. 1981)). In *Grumman*, the bankruptcy court found the "Fredericos had no 'contact' with Grumman prior to the accident. They did not deal with Grumman and Ms. Frederico's only connection was that her employer purchased the truck and she drove it. Hence, they did not hold claims against the Grumman estate at the time of the bankruptcy sale." *In re Grumman Olson Indus., Inc.*, 445 B.R. at 253.

In addition, the bankruptcy court found that due process had not been satisfied because the Claimants could not have been identified as future creditors at the time notice of the sale was given, and that even if they had received notice of the sale, such knowledge would be meaningless to them because no harm had yet occurred. *Id.* at 254. The Buyer subsequently appealed the bankruptcy court's decision to the district court.

District Court Affirms

On March 29, 2012, the district court issued its decision affirming the bankruptcy court, finding that the future claims held by the Claimants did not constitute "claims" in bankruptcy, and that the sale notice provisions did not satisfy the Claimant's due process rights, nor could they, because there was "no way for anyone to know that the Fredericos ever would have a claim." *In re Grumman Olson Indus., Inc.*, 2012 WL 1038672 at *11.

Relying on virtually identical reasoning to that used by the bankruptcy court, the district court affirmed that future claims such as those held by the Claimant did not constitute "claims" at the time of the sale. The court also declined to express a formal view as to whether the appointment of a future claims representative, as can be "particularly useful in mass tort cases, such as those involving asbestos or medical implants, where a discernable class of potential claimants has already been exposed to the product," would be sufficient to satisfy the Claimants' due process rights. *Id.* at *12-14. In discussing the potential merits of a future claims representative, however, the court indicated its skepticism as to whether such a representative would have been effective in *Grumman*, noting that in the case of "unknown future claims" such as those held by the Claimants, in which there was no material exposure giving rise to a claim prior to the sale, courts often reject efforts by future claims representatives to set aside funds and otherwise act on behalf of future claimants. *Id.* at *13.

The court then turned to the due process component of the dispute, repeating the bankruptcy court's refrain that the Claimants could not possibly have had adequate notice, because even if they had received such notice it would have meant nothing to them because the claim had not yet arisen, nor was there a reasonable probability that such a claim would arise. The court then explored the tension between maximizing the value of the debtor's estate and the constitutional rights of prospective claimants. The court noted that it was "certainly cognizant of the inherent uncertainty that allowing successor liability claims (notwithstanding the "free and clear" provisions of the bankruptcy court's orders) imposes upon purchasers of debtor assets in bankruptcy. To whatever extent maximizing the value of the estate is an important policy under the Bankruptcy Code, it is no more fundamental than giving claimants proper notice and opportunity to be heard before their rights are affected." *Id.* at *13. Thus, the court "reject[s] the premise that maximizing the value of the estate outweighs the due process rights of potential claimants." *Id.* at *14.

Implications of *Grumman* on Section 363 Sales

Both the bankruptcy court and the district court in *Grumman* firmly denied that future tort claims like those of the Fredericos constitute "claims" at the time of a § 363 sale, and that, moreover, it may be practically impossible to satisfy the due process rights of a future claimant bringing a successor liability claim that arises after the sale has taken place. Accordingly, potential purchasers of estate property pursuant to § 363 should beware that the broad "free and clear" language that is commonplace in § 363 sales may not protect them from potential successor liability if the traditional factors for such liability under state law are present. Such factors include, but are not limited to, continuation of a business line, use of the same facilities, use of the same customer

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New Lenders, the transfers actually benefited the Transeastern Lenders because they were able to receive the settlement proceeds only as a result of the lien transfers.

Bankruptcy Court Finds in Favor of Committee

The Bankruptcy Court ruled in favor of the Committee, holding that the Conveying Subsidiaries: 1) did not receive reasonably equivalent value in exchange for the lien transfers and proceeds transfer; 2) were insolvent both before and after the date of the July 2007 transaction; and 3) were left with unreasonably small capital with which to operate their businesses as a result of the July 2007 transaction. *Official Comm. Unsecured Creditors of TOUSA, Inc. v. Citicorp N. Am. Inc.* (*In re TOUSA, Inc.*), 422 B.R. 783 (Bankr. S.D. Fla. 2009).

The Bankruptcy Court avoided the lien transfer on the basis that the Conveying Subsidiaries did not receive "reasonably equivalent value" for the transfers by narrowly interpreting the meaning of "value," finding that value includes "*only* 'property' and 'satisfaction or securing of a present or antecedent debt of the debtor." 422 B.R. at 868. In this case, the Conveying Subsidiaries did not receive any property in exchange for the lien transfer because they did not receive any of the new loan proceeds. Rather, the new loan documentation specifically provided that the new loan funds be transferred to the Transeastern Lenders for the settlement of the TOUSA litigation. In addition, the Conveying Subsidiaries did not receive the satisfaction of a present or antecedent debt because the Conveying Subsidiaries did not have any obligations under the Transeastern loans or settlement. As a result, the Conveying Subsidiaries did not receive reasonably equivalent value from the Transeastern Lenders in exchange for the transfers.

The Bankruptcy Court explicitly rejected the Transeastern Lenders' arguments that they had provided value to the Conveying Subsidiaries in that their settlement with TOUSA and Tousa Homes prevented the occurrence of an event of default on debt that the Conveying Subsidiaries had guaranteed, which would have likely resulted in an immediate bankruptcy filing by the Conveying Subsidiaries. As a result, the settlement delayed the Conveying Subsidiaries' bankruptcy filings and gave them the opportunity to continue their operations. Unconvinced, the Bankruptcy Court held that the Conveying Subsidiaries had not received any direct value as a result of the transaction and that, if they had received "any value at all, it was minimal and did not come anywhere near the millions of dollars of obligations they incurred." 422 B.R. at 844.

In addition, the Bankruptcy Court held that the Transeastern Lenders were entities "for whose benefit" the transfers were made under section 550(a)(1) of the Bankruptcy Code, allowing the Committee to recover the proceeds transferred to the Transeastern Lenders.

In issuing its decision the Bankruptcy Court ordered $403 million, plus interest and fees, of the $421 million paid to the Transeastern Lenders set aside as a fraudulent transfer and disgorged. Not surprisingly, the Transeastern Lenders appealed the Bankruptcy Court's decision to the District Court.

District Court Quashes And Reverses Bankruptcy Court's Ruling

In the *TOUSA* case's first twist, the District Court on appeal vehemently disagreed with the Bankruptcy Court's findings and ruling, ultimately quashing the Bankruptcy Court's decision. *3V Capital Master Fund Ltd. v. Official Comm. Unsecured Creditors of TOUSA, Inc.* (*In re TOUSA, Inc.*), 444 B.R. 613 (S.D. Fla. 2011). One of the main issues on appeal was whether, for purposes of § 548(a)(1)(B) of the Bankruptcy Code, the Conveying Subsidiaries had received reasonably equivalent value in exchange for their liens and obligations under the new loans, as well as for the transfer of the new loan proceeds by ULT to the Transeastern Lenders. Holding that the Bankruptcy Court's ruling was clearly erroneous, the District Court found that the Conveying Subsidiaries' ability to avoid bankruptcy as a result of the transaction provided "indirect, intangible, economic benefits, including the opportunity to avoid default, to facilitate the enterprise's rehabilitation, and to avoid bankruptcy, even if it provided to be short lived" and that such benefits constituted sufficient value "so long as the expectation was legitimate and reasonable." 444 B.R. at 660.

The District Court held further that the Bankruptcy Court's definition of "value" was overly narrow and that "a debtor's opportunity to improve its prospects of avoiding bankruptcy are precisely the kind of benefits that, by decision, are not susceptible to exact quantification but are nonetheless legally cognizable under section 548." 444 B.R. at 660.

In addition, the District Court reversed the Bankruptcy Court's finding that the Transeastern Lenders were entities "for whose benefit" the transfers were made pursuant to § 550(a)(1) of the Bankruptcy Code. In holding so, the District Court stated that the "for whose benefit" language "does not apply where the 'benefit' is not the immediate and necessary consequence of the initial transfer, but flows from the manner in which the initial transfer is used by its recipient." 444 B.R. at 674. In other words, the Transeastern Lenders had only received the new loan proceeds, not the liens of the Conveying Subsidiaries. The transfer of the new loan proceeds was not a direct consequence of the transfer of liens to the New Lenders. Rather, the New Lenders received the immediate benefit of the lien transfers, and the Transeastern Lenders received the new loan proceeds backed by the liens, which was not the immediate and necessary consequence of the lien transfer. As a

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result, the District Court found that the Transeastern Lenders were too far removed from the lien transfer to be held liable as initial transferees for the fraudulent transfers.

The Committee then appealed the District Court's decision to the Court of Appeals.

Bankruptcy Court Didn't 'Clearly Err'

In a second twist, the Court of Appeals reversed the District Court's ruling and reinstated the ruling of the Bankruptcy Court, finding that the Bankruptcy Court did not "clearly err" when it ruled against the Transeastern Lenders. In doing so, the Court of Appeals agreed with the Bankruptcy Court that the Conveying Subsidiaries did not receive reasonably equivalent value for their lien transfers to the New Lenders. 2012 WL 1673910, at *12-14. Declining to decide whether the definition of "value" had been interpreted too narrowly by the Bankruptcy Court or too broadly by the District Court, the Court of Appeals held that even if the delay or avoidance of the Conveying Subsidiaries could be considered "value," such value was entirely outweighed by the cost of the transaction. *Id*. at *12.

The Court of Appeals also reaffirmed the Bankruptcy Court's findings that the Transeastern Lenders were entities from whom the Committee could recover under Bankruptcy Code section 550(a)(1). *Id*. at *16. In doing so, the Court of Appeals reviewed the plain language of the statute and relied on the language of the new loan documents, which expressly provided that the proceeds of the new loan be used to satisfy TOUSA's settlement with the Transeastern Lenders. As a result, the Court of Appeals held that it didn't matter that the funds passed through ULT before they were wired to the Transeastern Lenders because the Conveying Subsidiaries never had control over the funds. As a result, the Transeastern Lenders were the initial transferees of the Conveying Subsidiaries' liens.

Implications

For better or worse, the Court of Appeals has provided some finality on the *TOUSA* question of whether the Conveying Subsidiaries received reasonably equivalent value for their lien transfers. Because the Court of Appeals did not adopt the Bankruptcy Court or the District Court's definition of "value," however, it remains to be seen how future fraudulent transfer cases will be decided in light of *TOUSA*.

If nothing else, the *TOUSA* case provides a good reminder to lenders that, especially with respect to "upstream" loan transactions, they must act with an utmost duty of diligence and due care when analyzing the solvency of a prospective borrower. Lenders should also ensure that any subsidiary company that will be providing an upstream guaranty in a loan transaction is either solvent at the time of the transaction or that it will receive a tangible benefit as a result of the transaction. Some questions that lenders and official committees in Chapter 11 cases investigating potential fraudulent transfer claims should ask themselves when reviewing loan transactions include the following:

1. Which company holds the assets? Lenders should lend to the company that holds the assets. This will ensure the likelihood that the lender will be reimbursed by the company and, as a result, the transaction may not need to involve subsidiary companies.

2. If a subsidiary is going to act as a guarantor for a parent company's loan, is such subsidiary going to receive any value for its role in the transaction? If not, then the transaction may have a *TOUSA* issue. The documentation surrounding the transaction should include factual representations or recitals, signed by the subsidiary company, specifically detailing the value that such subsidiary is going to be receiving for its role in the transaction.

3. Are the companies that are to be involved in the loan transaction solvent? Lenders should measure the financial strength of each company to be involved in the transaction, whether such company will be acting as a borrower, guarantor or in some other role. Part of such review should include ensuring that the lender has received accurate and updated audited financial information from all companies that are to be involved in the transaction to ensure that such companies are solvent and able to pay their debts as they come due. While solvency opinions should be included as part of the loan documentation, lenders should conduct their own independent review of each company's financial information as well to test for solvency.

4. How are the companies managed? Lenders should be familiar with the operating agreements and boards or managers of each company to be involved in the transaction. Subsidiary companies that will be involved in the transaction should provide lenders with clear authority from its directors in the form of a resolution or otherwise to enter into the transaction and such resolution should again recite the value that the subsidiary will receive for its role in the transaction.

5. How will the closing of the transaction affect the companies financially? Lenders should not loan funds to companies and then turn a blind eye to the effects of the loan. Rather, lenders should review the balance sheet of each company that will be involved in the loan and should then work with the company to project what the balance sheets will look like after the closing of the loan. In this way, lenders will be able to get comfort that the companies will be able to service the debt on a go-forward basis.

Conclusion

Any loan transactions involving upstream guaranties should be carefully reviewed for *TOUSA* issues, and the latest ruling by the Court of Appeals makes clear that all parties involved in such a transaction should be alert for potential fraudulent transfer issues.

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RadLAX Ruling

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The Intersection of Credit Bidding and Cramdowns Under the Bankruptcy Code

Credit Bidding

Credit bidding is the practice by which a secured creditor may bid for a debtor's collateral by using the debt it is owed to offset the purchase price. Credit bidding is specifically authorized by § 363(k) of the Bankruptcy Code, which provides that in a § 363 sale of property subject to a secured claim, the secured creditor may bid on the property by offsetting its claim against the purchase price of the property being sold, unless the court orders otherwise "for cause." 11 U.S.C. § 363(k).

Thus, a creditor with an allowed claim secured by a lien on property that is to be sold pursuant to a § 363 sale may use some or all of the amount of its allowed claim to bid. The creditor will be required to put up new capital only if the bidding goes above the amount of the creditor's allowed claim. The only exception would be if the court found that cause existed to deny the right to credit bid, which is only appropriate in circumstances where the creditor has been found to have engaged in some type of inequitable conduct.

Cramdown

In most cases, for a debtor to obtain confirmation of a Chapter 11 plan, each impacted class of creditors must vote in favor of the plan. However, in certain circumstances, the bankruptcy court may confirm a plan over the objections of an impaired class so long as the plan is "fair and equitable." This is commonly referred to as a "cramdown."

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Bankruptcy Code § 1129(b)(2)(A) provides three avenues by which a debtor may provide fair and equitable treatment and thus cramdown a plan over the objection of a class of secured claims. Section 1129(b)(2)(A)(i) allows for a plan to be crammed down where the holder of the secured claim will retain its lien. Section 1129(b)(2)(A)(ii) allows the debtor to sell property free and clear of a secured creditor's lien, but subject to § 363(k), which means that the secured creditor retains its right to credit bid. Finally, under § 1129(b)(2)(A)(iii), a plan can be deemed "fair and equitable" and thus eligible for confirmation if the objecting class of secured creditors receives the "indubitable equivalent" of its claims. 11 U.S.C. § 1129(b)(2)(A)(i)-(iii).

Until the Third and Fifth Circuit decisions imposing restrictions on secured creditors' rights to credit bid were announced, practitioners generally assumed that if a plan called for a sale of property subject to a lien, the confirmability of the plan with respect to the treatment of the secured creditor would be evaluated under clause (ii) of § 1129(b)(2)(A), which explicitly incorporates § 363(k). Clause (i) is clearly not relevant in such a case, because it only applies to situations in which the debtor is planning to retain, rather than to sell, the property. Clause (iii) is essentially a "catch-all" provision for other types of plans, one that requires the debtor to provide indubitable equivalence in order to adequately compensate the secured creditor for its interest in the property. *See In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935).

Consequently, it was long assumed that if a plan's proponent wanted to successfully cramdown a plan that included a sale of encumbered assets, the plan would have to account for the secured creditor's ability to credit bid. But that view was called into question in light of the Fifth Circuit's decision in *Pacific Lumber*. It was cast into further doubt with the Third Circuit's decision in *Philadelphia Newspapers*, which approved sale procedures under Bankruptcy Code § 1129(b)(2)(A) that denied the secured creditor an opportunity to credit bid.

The *RadLAX* Case in the Lower Courts

Shortly after the Third Circuit's decision in *Philadelphia Newspapers*, the Northern District of Illinois bankruptcy court was confronted with the same issue in the case that eventually wound up before the Supreme Court: *In re River Road Hotel Partners, LLC*, 2010 Bankr. LEXIS 5933 (Bankr. N.D. Ill. Oct. 5, 2010). In this case, prior to their bankruptcy, debtors RadLAX Gateway Hotel, LLC, and RadLAX Gateway Deck, LLC (collectively, the Debtors) purchased the Radisson Hotel at Los Angeles International Airport, as well as an adjoining lot, on which they planned to build a parking lot. The Debtors obtained a $142 million loan to finance the refurbishment of the hotel and to complete construction of the parking lot, pledging substantially all of their assets to secure the loan.

Due to higher than expected construction costs, the Debtors were unable to repay the loan, and eventually they filed petitions for reorganization under Chapter 11. The Debtors thereafter filed a Chapter 11 plan, pursuant to which they proposed to sell substantially all of their assets free and clear of the secured lender's liens. As part of their plan and related auction and bidding procedures, the Debtors sought to eliminate the secured lender's right to credit bid. Given the inevitability that the lender would object to their plan, the Debtors, just like the debtors in *Pacific Lumber* and *Philadelphia Newspapers*, sought to cram the lender down by utilizing the cramdown provision of § 1129(b)(2)(A)(iii).

Despite the Third and Fifth Circuit precedents approving the elimination of the secured creditors' right to credit bid, the bankruptcy court rejected the proposed bidding procedures and held that the Debtors' plan could not be confirmed over the objection of the secured creditor under § 1129(b)(2)(A). The court relied on the dissenting opinion in

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RadLAX Ruling

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Philadelphia Newspapers, which it believed set forth the better reading of the statute. The bankruptcy court also rejected the Debtors' motion to deny credit bidding "for cause" under Bankruptcy Code § 363(k). The bankruptcy court certified a direct appeal to the Seventh Circuit, which affirmed the bankruptcy court, finding that the Debtors' interpretation of 1129(b)(2)(A)(iii) would effectively nullify the requirements set forth in clauses (i) and (ii) of the section. The Debtors sought review by the Supreme Court, which granted *certiorari* to resolve the split among the circuits.

The Supreme Court's *RadLAX* Decision

The Supreme Court, in its unanimous (Justice Kennedy did not participate) and very brief (10 pages) *RadLAX* opinion, authored by Justice Scalia, affirmed the Seventh Circuit's decision. Rather than engage in a detailed analysis of the purposes of the Bankruptcy Code, pre-Code practices, the relevant legislative history, or the intrinsic merits of credit bidding and related policy considerations — as the parties and the lower courts had done to varying degrees — the Supreme Court instead proceeded directly to what it viewed as the crux of the matter, which was purely one of statutory construction.

The Court framed the issue as whether a Chapter 11 plan may be confirmed over the objection of a secured creditor under § 1129(b)(2)(A) if the plan provides for the sale of collateral free and clear of the creditor's lien, but does not permit the creditor to credit bid at the sale. The Court then answered that question in the negative.

The Court found the Debtors' reading of § 1129(b)(2)(A), under which clause (iii) allows precisely what clause (ii) forbids, to be "hyperliteral and contrary to common sense." Relying on the canon of statutory interpretation that the specific governs the general, the Court reasoned that if it accepted the Debtors' argument, the specific provision of clause (ii) would be completely negated by the more general clause (iii). This, in turn, would violate the "cardinal rule that, if possible, effect shall be given to every clause and part of a statute."

The Court explained that the general language of clause (iii), although broad enough literally speaking to include clause (ii), would not be held to apply to a matter already specifically dealt with in clause (ii). Under well-established canons of statutory interpretation, when the conduct at issue falls under both a general provision and a specific provision, the specific provision presumptively governs, making this case an "easy" one. The Debtors' plan providing for the sale of secured property free and clear of the secured creditor's lien could not be confirmed without affording the secured creditor the right to credit bid for the property under section 1129(b)(2)(A)(ii).

Implications for Chapter 11 Debtors and Secured Creditors

Credit bidding has long been available as an important creditor protection in the context of a Chapter 11 debtor's disposition of collateral. As explained in *RadLAX*, the ability to credit bid protects a secured creditor against the risk that its collateral will be sold at a depressed price, by enabling the creditor to purchase the collateral for what it considers to be the fair market value of the property.

The recent decisions from the Third and Fifth Circuits created considerable doubt about the availability of credit bidding in the Chapter 11 plan context. But with the Supreme Court's unambiguous rejection of the use of Bankruptcy Code § 1129(b)(2)(A)(iii) to strip a secured creditor of the right to credit bid, secured creditors have scored a significant win.

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Successor Liability

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lists, continuation of the same employees, use of the existing name, etc. Care should be taken, particularly where certain sale property may be more prone to tort liability, to account for the attendant risk of potential successor liability exposure.

As the courts are concerned with the due process rights of those whose claims have not arisen at the time of the sale, it may be that the best the debtor and buyer can do is to take care to satisfy the due process rights of those whose claims do exist. It is well accepted that where the debtor is aware of a specific claimant who may have a contingent or unliquidated claim, actual notice to that claimant will be required to effect a sale free and clear of that claim. A prospective claimant may have suffered an injury and may not be aware of it (*e.g.*, exposure to a toxic substance). As the identity of that claimant is unknown, there are degrees of protection, some of which may be prohibitively expensive in light of the value of the subject property.

At a minimum, where it is suspected that injuries exist and merely have not been sued on so that the debtor and the buyer do not know the identity of the potential claimant, notice by publication may be warranted. If it is known that a significant number of injuries exist because of, for example, the presence of carcinogens associated with the assets, if the costs can justify the effort, the parties may explore appointing a future claims representative and hiring actuaries to determine the cost in dealing with the likely claims. It may then be possible to use a Chapter 11 plan to funnel those claims into a special trust funded to deal with those claims. As the court indicated in *Grumman*, however, in the case of unknown future claims, even the appointment of a future claims representative may not protect against the imposition of successor liability on a purchaser.

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