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Preserving the Secured Creditor's Bargain in Chapter 11 Cramdown Scenarios

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PRESERVING THE SECURED CREDITOR'S BARGAIN IN CHAPTER 11 CRAMDOWN SCENARIOS

INTRODUCTION

The Bankruptcy Clause of the U.S. Constitution permits Congress to enact federal laws that preempt citizens' state law rights in bankruptcy proceedings.[1] When a debtor files a bankruptcy petition, the Bankruptcy Code modifies the state law contract rights of his or her creditors.[2] Although some modifications, such as the automatic stay, may only be temporary,[3] others permanently inhibit the creditor's ability to invoke state law collection rights against the debtor.[4] One of the central policy debates in bankruptcy scholarship addresses how much—and to what end—the Bankruptcy Code should modify the contract rights of creditors in bankruptcy proceedings.[5]

Creditors whose loans are secured by collateral (secured creditors) receive a greater level of protection from the Bankruptcy Code than do general unsecured creditors.[6] However, the Bankruptcy Code does not guarantee that the contract rights of secured creditors will be preserved entirely. One important modification of the rights of secured creditors that is permitted under Chapter 11 of the Bankruptcy Code[7] is embodied in the "cramdown" provision of 11 U.S.C. § 1129(b)(2)(A). This provision permits a bankruptcy court to approve a plan of reorganization even over the objection of secured creditors.[8] The three clauses of 11 U.S.C. § 1129(b)(2)(A) set out the limited circumstances under which a bankruptcy court may approve a plan of reorganization that modifies the rights of secured creditors without their consent.[9] Thus, it outlines three ways in

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1. U.S. CONST. art. I, § 8, cl. 4; *see also* Ralph Brubaker, *Explaining Katz' New Bankruptcy Exceptions to State Sovereign Immunity: The Bankruptcy Power as a Federal Forum Power*, 15 AM. BANKR. INST. L. REV. 95, 119 (2007).
2. *See, e.g.*, 11 U.S.C. § 362 (2012).
3. *See, e.g.*, *id.* § 362(d) (setting out circumstances under which a bankruptcy court will grant relief from the automatic stay).
4. *See, e.g.*, *id.* § 727 (providing for discharge of debt).
5. *See, e.g.*, Douglas Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 822–25 (1987); Thomas H. Jackson, *Bankruptcy, Nonbankruptcy Entitlements, and the Creditor's Bargain*, 91 YALE L.J. 857, 862 (1982); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 781 (1987) ("Although this distinction between substantive rights and collection rules might seem obvious, it is important to the policy debate, which often centers on the degree to which bankruptcy law should 'rely' on underlying state law.").
6. ELIZABETH WARREN, CHAPTER 11: REORGANIZING AMERICAN BUSINESSES 156 (2008).
7. Chapter 11 is the portion of the Bankruptcy Code that provides for the alteration of businesses' debt obligations under the federal bankruptcy laws. *Id.* at 4.
8. 11 U.S.C. § 1129(b).
9. *Id.* § 1129(b)(2)(A).

which the Bankruptcy Code permits the permanent modification of secured creditors' contract rights in Chapter 11 proceedings.

Several recent cases have addressed this provision and the degree of protection that it affords to secured creditors.[10] In *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, a Supreme Court decision resolving a circuit split between the Seventh Circuit and the Third and Fifth Circuits, the Court affirmed the right of secured creditors to credit bid[11] at auctions of their collateral under 11 U.S.C. § 1129(b)(2)(A)(ii).[12] A separate Seventh Circuit decision, *In re River East Plaza, LLC*, struck down a plan that both stretched out the repayment period and replaced the creditor's collateral with substitute collateral.[13] Ultimately, both courts interpreted the statute in a way that gave robust protection to the contract rights of secured creditors.

Such protection is consistent with an approach to bankruptcy policy known as the "creditor's-bargain" approach. Proponents of this approach argue that the purpose of Chapter 11 bankruptcy is to solve the collective action problem that arises when debtors with multiple creditors default on their loans.[14] Chapter 11 bankruptcy is a means of ensuring that the debtor's assets will be used in a way that maximizes returns to creditors.[15] Thus, the Bankruptcy Code should only facilitate a business's survival if its going-concern value is greater than its liquidation value.[16] Since creditors with security interests have bargained for priority in the state law hierarchy of repayment,[17] the Bankruptcy Code's primary objective should be to preserve this hierarchy to the extent possible.[18] From this perspective, the decisions in *RadLAX Gateway Hotel, LLC* and *River East Plaza, LLC* were correctly decided because they rejected plans that upset the state law

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10. RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065, 2069–70 (2012); *In re* River E. Plaza, LLC, 669 F.3d 826, 828 (7th Cir. 2012); *In re* River Rd. Partners, LLC, 651 F.3d 642, 646 (7th Cir. 2011); *In re* Phila. Newspapers, LLC, 599 F.3d 298, 304 (3d Cir. 2010); *In re* Pac. Lumber Co., 584 F.3d 229, 244–45 (5th Cir. 2009).

11. 11 U.S.C. § 363(k) provides secured creditors whose collateral is sold the right to bid at the sale of that collateral, and if they successfully purchase the collateral, they "may offset such claim against the purchase price of such property." This practice is known as "credit bidding." *In re Phila. Newspapers, LLC*, 599 F.3d at 302 n.4.

12. *RadLAX Gateway Hotel, LLC*, 132 S. Ct. at 2073.

13. *In re River E. Plaza, LLC*, 669 F.3d at 834.

14. Jackson, *supra* note 5, at 862.

15. Warren, *supra* note 5, at 798.

16. A firm's going-concern value is its value as a functioning business, without the threat of liquidation. MICHAEL A. GERBER & GEORGE W. KUNEY, BUSINESS REORGANIZATIONS 94 (3d ed. 2013). A firm's liquidation value is the total value of a company's physical assets. *Id.* at 93. Proponents of the creditor's-bargain approach argue that a business that files under Chapter 11 should only survive if its survival would increase the amounts received by creditors. Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 109 (1984).

17. Baird & Jackson, *supra* note 16, at 112.

18. *Id.* at 129.

hierarchy of repayment, effectively permitting payments to junior creditors before senior creditors were paid in full.

The Third and Fifth Circuits interpreted § 1129(b)(2)(A) in a way that is consistent with another prominent approach to bankruptcy policy, which I will refer to as the "optimal loss distribution" approach. Proponents of this view note that bankruptcy proceedings invariably result in losses for many of the constituencies affected by the bankruptcy,[19] and they argue that a principal role of bankruptcy is the optimal distribution of such losses.[20] Under this approach, the role of Chapter 11 is to address a broad range of social problems caused by business failure.[21] Thus, bankruptcy courts should consider not only the interests of secured and unsecured creditors, but also the interests of the firm itself, as well as its employees, customers, and suppliers.[22] From this perspective, the Supreme Court's interpretation of § 1129(b)(2)(A) in *RadLAX Gateway Hotel, LLC* and the Seventh Circuit's interpretation in *River East Plaza, LLC* essentially closed off two avenues of discretion through which bankruptcy judges could take such considerations into account.

This Note will examine § 1129(b)(2)(A)'s function in the Bankruptcy Code and the policy implications of recent interpretations of this provision. Part I of this Note will explore the relevant portions of the Bankruptcy Code. Part II will summarize the recent decisions interpreting § 1129(b)(2)(A). Part III will summarize two competing approaches to bankruptcy policy that help to illuminate what is at stake in the courts' interpretations of this provision. Part IV will argue that the prevailing interpretations are sound and that in the context of § 1129(b)(2)(A), preservation of the state law bargains made by secured creditors should be the guiding policy consideration.

19. Warren, *supra* note 5, at 785.
20. *Id.*
21. Baird & Jackson, *supra* note 16, at 101.
22. Warren, *supra* note 5, at 787–88.

I. SECTION 1129(b) AND THE PROTECTION OF SECURED CREDITORS IN CHAPTER 11 PROCEEDINGS

One of the central elements of the Chapter 11 process is the confirmation of the firm's plan of reorganization,[23] which typically results in some modification of the debt obligations of the debtor business.[24] When a business files a bankruptcy petition, an automatic stay immediately goes into effect, preventing all creditors from taking any action to recover their debts.[25] Creditors are grouped into classes based on the types of claims that they hold against the debtor.[26] In Chapter 11 proceedings, the debtor is given a certain amount of time to propose a plan of reorganization for approval by the bankruptcy court (the exclusivity period),[27] after which the different classes of creditors are permitted to submit their own plans for approval.[28]

Generally, confirmation of the plan of reorganization is contingent upon the consent of each class of creditors.[29] However, in the event that the debtor cannot obtain the approval of each class of creditors, the Bankruptcy Code provides the debtor with an alternative route to confirmation, which is set out in § 1129(b).[30] Section 1129(b) of the Bankruptcy Code permits the bankruptcy court to approve a plan of reorganization without the consent of every class of the creditors,[31] but it also prescribes strict criteria with which such a plan must comply.[32] According to this provision, the bankruptcy court should only approve a plan of reorganization if the plan conforms to every requirement of § 1129(a) besides the requirement that all creditors consent, and as long as such a plan is "fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."[33]

The Code goes on to specify the criteria for "fair and equitable" treatment with regard to secured creditors in § 1129(b)(2)(A), which sets forth the three types of plans that will meet this standard.[34] The first two clauses indicate specific modifications that a bankruptcy court will permit. Under clause (i) (Path One), a court will approve any plan in which the secured creditors retain their liens and receive "deferred cash payments totaling at least the allowed amount of such claim . . . as of the effective

23. WARREN, *supra* note 6, at 134.
24. *Id.* at 147.
25. 11 U.S.C. § 362(a) (2012).
26. WARREN, *supra* note 6, at 150.
27. *Id.* at 136.
28. 11 U.S.C. § 1121.
29. *Id.* § 1129(a)(8).
30. *Id.* § 1129(b).
31. *Id.*
32. *Id.* § 1129(b)(2)(A).
33. *Id.* § 1129(b)(1).
34. *Id.* § 1129(b)(2)(A).

date of the plan."[35] Secured creditors who retain their liens under this provision but who are still not fully secured[36] are also permitted, under § 1111(b), to elect that their claims be treated as fully secured.[37] Under clause (ii) (Path Two), a court will approve any plan that proposes to pay the secured creditor the proceeds from the sale of the collateral, as long as the secured creditor is provided the right to credit bid at the sale pursuant to § 363(k).[38] Thus, §§ 363(k) and 1111(b) are means by which secured creditors can protect themselves when reorganization plans are "crammed down" under Path One or Path Two without their consent.[39]

Clause (iii) (Path Three) sets out a less precisely defined route to confirmation. Under this clause, a court will approve any plan that strips a creditor of its lien, but Path Three provides for the "realization by such [creditor] of the indubitable equivalent" of its claims.[40] The phrase "indubitable equivalent" is taken from Judge Learned Hand's opinion in *In re Murel Holding Corp.*, where the court rejected a repayment plan that proposed to strip the creditor of its lien and repay the balance of the secured debt in a balloon payment ten years after confirmation of the plan.[41] Judge Hand held that a secured creditor could not be deprived of its collateral "unless by a substitute of the most indubitable equivalence."[42] However, "indubitable equivalent" remains a poorly defined standard, as the *In re Pacific Lumber Co.* court observes: "What measures constitute the indubitable equivalent of the value of the Noteholders' collateral are rarely explained in caselaw, because most contested reorganization plans follow familiar paths outlined in Clauses (i) and (ii)."[43]

Section 1129(b)'s protection of secured creditors in cramdown scenarios is an application of what is known as the "absolute priority rule."[44] This rule requires that senior creditors be paid in full before junior creditors are paid at all, thus creating a hierarchy of rights of repayment.[45] A reorganization plan that adhered to this rule would pay all secured

35. *Id.* § 1129(b)(2)(A)(i).

36. A secured creditor is fully secured when the value of its collateral matches or exceeds the value of its claim. WARREN, *supra* note 6, at 47. A secured creditor is under-secured when its claim exceeds the value of the collateral. *Id.* at 47–48. Under 11 U.S.C. § 506, such creditors' claims are bifurcated, so that a secured creditor has a secured claim equal in amount to the value of the collateral and an unsecured claim for the remainder.

37. 11 U.S.C. § 111(b); *see also* WARREN, *supra* note 6, at 157–59 ("The undersecured creditor whose claim is bifurcated into its secured and unsecured portions for treatment under the plan is permitted to waive its unsecured claims and demand instead full repayment of its total claim (11 U.S.C. § 1111(b)(1)(B)).").

38. 11 U.S.C. § 1129(b)(2)(A)(ii) ("[F]or the sale, subject to section 363(k) of this title . . . .").

39. *In re* Phila. Newspapers, LLC, 599 F.3d 298, 333 (3d Cir. 2010) (Ambro, J., dissenting).

40. 11 U.S.C. § 1129(b)(2)(A)(iii).

41. *In re* Murel Holding Corp., 75 F.2d 941, 942 (2d Cir. 1935).

42. *Id.* at 942.

43. *In re* Pac. Lumber Co., 584 F.3d 229, 246 (5th Cir. 2009).

44. *Id.* at 244.

45. WARREN, *supra* note 6, at 156.

creditors the full value of their collateral before paying anything to unsecured creditors, would pay priority unsecured creditors in full before paying general unsecured creditors anything, and would pay general unsecured creditors in full before paying equity holders anything.[46] Path One preserves this principle by requiring debtors to pay "at least the allowed amount"[47] of the secured creditors' claims, and secured creditors are further protected by the requirement that they retain their liens on the collateral. Path Two preserves this principle by protecting secured creditors from the danger of undervaluation at sales of their collateral. The extent to which Path Three preserves this principle is the issue that is addressed by the cases discussed in this Note.

II. RECENT DEVELOPMENTS IN THE INTERPRETATION OF § 1129(b)(2)(A)

The proper interpretation of § 1129(b)(2)(A) has been the subject of recent litigation in U.S. Courts of Appeal and the Supreme Court.[48] All of the cases discussed in this Note address plans of reorganization that strip secured creditors of their collateral "in the name of indubitable equivalence."[49] In the circuit split resolved by *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, the debtor reorganization plans all proposed to pay the secured creditors the value of their collateral[50] as the "indubitable equivalent" of their liens on the collateral, without permitting them to credit bid at the auctions,[51] as required under Path Two.[52] In the case of *River East Plaza, LLC*, the debtor's plan proposed to make deferred payments, as provided under Path One,[53] while transferring the secured creditor's lien to treasury bonds of supposedly "indubitably equivalent" value.[54] Thus, all of the debtors in these cases attempted to circumvent the requirements of Paths One and Two by claiming that their plans met the indubitable-equivalence standard of Path Three.[55] Both the Supreme Court and Seventh Circuit

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46. *Id.*

47. 11 U.S.C. § 1129(b)(2)(A)(i)(II) (2012).

48. *See, e.g.*, RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065, 2069–70 (2012); *In re* River E. Plaza, LLC, 669 F.3d 826, 828 (7th Cir. 2012); *In re* River Rd. Partners, LLC, 651 F.3d 642, 646 (7th Cir. 2011); *In re* Phila. Newspapers, LLC, 599 F.3d 298, 304 (3d Cir. 2010); *In re Pac. Lumber Co*., 584 F.3d 229, at 244–45.

49. *In re River E. Plaza, LLC*, 669 F.3d at 829.

50. In *RadLAX Gateway Hotel, LLC*, 132 S. Ct. at 2067, and *Philadelphia Newspapers, LLC*, 599 F.3d at 301, the value was determined by an auction. In *Pacific Lumber Co*., 584 F.3d at 238, the value was determined by the court.

51. *See, e.g.*, *In re River Rd. Partners, LLC*, 651 F.3d at 645; *In re Phila. Newspapers, LLC*, 599 F.3d at 302; *In re Pac. Lumber Co*., 584 F.3d at 239.

52. 11 U.S.C. § 1129(b)(2)(A)(ii).

53. *Id.* § 1129(b)(2)(A)(i)(II).

54. *In re River E. Plaza, LLC*, 669 F.3d at 829.

55. 11 U.S.C. § 1129(b)(2)(A)(iii).

struck these plans down as failing to protect the rights of secured creditors to the extent mandated by their interpretations of the statute.[56]

A. THE SECURED CREDITOR'S RIGHT TO CREDIT BID UNDER § 1129(b)(2)(A)(ii)

The circuit split that was resolved in *RadLAX Gateway Hotel, LLC* concerned a dispute over whether a secured creditor has the right to credit bid at a sale of its collateral pursuant to § 1129(b)(2)(A).[57] Path Two of this section, the second option for cramdown approval, provides that if a secured creditor is to be compensated by proceeds from the sale of his collateral, such sale must conform to the requirements of 11 U.S.C. § 363(k),[58] which provides that when a reorganization plan involves the sale of collateral, the secured creditor must be permitted to credit bid up to the value of its claim.[59] In *Pacific Lumber Co.* and *In re Philadelphia Newspapers, LLC*, the Third and Fifth Circuits both found that plans that did not permit the secured creditor to credit bid at the sales of their collateral could still pass the "fair and equitable" test under the indubitable-equivalence standard of Path Three.[60] These courts reasoned that the proceeds from the sale of the collateral were the indubitable equivalent of that collateral, so it did not matter that the sales did not conform to Path Two's requirement that the secured creditor have the right to credit bid at the sale.[61]

In *Pacific Lumber Co.*, the Fifth Circuit addressed a reorganization plan that proposed to pay a group of secured creditors, who had liens on a 200,000-acre tract of "prime redwood timberland" (the Timberlands), the court-determined value of the property.[62] The principal debtors in the case were Pacific Lumber Company and Scotia Pacific LLC.[63] Pacific Lumber Company owned and operated a sawmill and power plant.[64] Scotia Pacific LLC, a special purpose entity wholly owned by Pacific Lumber, owned the Timberlands.[65] Scotia Pacific gave Pacific Lumber the sole right to harvest its timber, which Pacific Lumber then processed and sold.[66] The

56. RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065, 2070 (2012); *In re River E. Plaza, LLC*, 669 F.3d at 828.

57. *In re* River Rd. Partners, LLC, 651 F.3d 642, 646 (7th Cir. 2011); *In re* Phila. Newspapers, LLC, 599 F.3d 298, 300 (3d Cir. 2010); *In re* Pac. Lumber Co., 584 F.3d 229, 247 (5th Cir. 2009).

58. 11 U.S.C. 1129(b)(2)(A)(ii).

59. *Id.* § 363(k).

60. *In re Phila. Newspapers, LLC*, 599 F.3d at 300; *In re Pac. Lumber Co*., 584 F.3d at 247.

61. *In re Phila. Newspapers, LLC*, 599 F.3d at 318 (affirming the district court's finding that a payment of sale proceeds to the secured lenders was an indubitable equivalent of its secured claim); *In re Pac. Lumber Co.*, 584 F.3d at 236.

62. *In re Pac. Lumber Co.*, 584 F.3d at 236.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

Timberlands were subject to a security interest held by the Bank of New York (the Noteholders).[67] At the time that Pacific Lumber filed for bankruptcy, Scotia Pacific owed the Noteholders $740 million.[68] When the debtor's exclusivity period passed without significant progress on a plan of reorganization, the court allowed other creditors to submit plans for approval.[69] Marathon Structured Finance (Marathon), one of Pacific Lumber's creditors, submitted a plan that proposed to pay the Noteholders the court-determined value of the Timberlands, while stripping them of their liens on the property.[70] The court ultimately approved this plan.[71]

The Noteholders, who believed that the value of the property far exceeded the court-determined value and were nevertheless denied the right to credit bid as required under Path Two, objected to the plan.[72] While the secured lenders had a claim in the amount of $720 million, the court valued the property at just $510 million.[73] Despite the objection of the Noteholders, the Fifth Circuit concluded that the $510 million that they received satisfied the indubitable-equivalence standard of Path Three.[74] The court found that the disjunctive "or" in § 1129(b)(2)(A) indicates that the three clauses are alternatives and that a plan of reorganization only had to satisfy one alternative.[75] The *Pacific Lumber Co.* court reasoned that a plan that met the indubitable-equivalence standard of Path Three did not have to conform to the credit-bidding requirement of Path Two.[76] The court argued that the bankruptcy court's valuation was reasonably accurate.[77] It went on to conclude that payment of the value of the collateral satisfied the indubitable-equivalence standard, arguing that "paying off the secured creditors in cash can hardly be improper if the plan accurately reflected the value of the Noteholders' collateral."[78]

In *Philadelphia Newspapers, LLC*, the Third Circuit came to a similar conclusion. In that case, debtor Philadelphia Newspapers, LLC, which owned and operated the *Philadelphia Inquirer* and the *Philadelphia Daily News*, had granted a consortium of lenders a security interest in most of its tangible assets.[79] The value of the loan at the time of filing was $318

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67. *Id.*
68. *Id.* at 237.
69. *Id.*
70. *Id.*
71. *Id.* at 249.
72. *Id.* at 245. The court characterizes this transfer of property as a sale, noting that Marathon and its subsidiaries "received title to the assets in exchange for this purchase. That the transaction is complex does not fundamentally alter that it involved a 'sale' of the Noteholders' collateral." *Id.*
73. *Id.* at 238.
74. *Id.* at 245.
75. *Id.*
76. *Id.*
77. *Id.* at 248.
78. *Id.* at 247.
79. *In re* Phila. Newspapers, LLC, 599 F.3d 298, 301 (3d Cir. 2010).

million.[80] After filing for bankruptcy under Chapter 11, the debtors submitted a reorganization plan under which it would pay the secured creditors the proceeds from the sale of all of its assets without allowing them to credit bid at the auction.[81] As the dissent notes, these assets were sold to an entity controlled by the current management of the debtor business and owned largely by the debtor's equity holders[82] at a price that was a fraction of the secured claim.[83] The debtors, citing *Pacific Lumber Co.*, argued that payment of the proceeds from the sale of the collateral satisfied the indubitable-equivalence standard of Path Three.[84] The Third Circuit agreed.[85]

The court based its decision mainly on its interpretation of the statute and congressional intent, but it also touched on public policy considerations. The court first reasoned that "the specificity of subsection (ii)" does not operate as "a limitation on the broader language of subsection (iii)."[86] The court also rejected the argument advanced by the objecting creditors, as well as the dissent (discussed below),[87] that §§ 363(k), 1111(b), 1123(a)(5)(D), and 1129(b)(2)(A), taken together, demonstrate the intention of Congress to provide maximum protection to secured creditors' interests in their collateral.[88] In its policy discussion, the court suggests that the purpose of Chapter 11 is not to ensure the greatest possible return for secured creditors, but rather to balance the interests of the parties involved: "Chapter 11 of the Bankruptcy Code strikes a balance between two principal interests: facilitating the reorganization and rehabilitation of the debtor as an economically viable entity, and protecting creditors' interests by maximizing the value of the bankruptcy estate."[89] Elsewhere the court states that the Bankruptcy Code, as a whole, is designed "to balance the interests of the secured lender and the protection of the reorganized entity" and that nothing in the Code suggests that lenders should be "ensure[d] an advantageous return on a secured investment."[90]

The dissent of *Philadelphia Newspapers, LLC* took a different approach, which the Seventh Circuit in *In re River Road Partners, LLC* and the Supreme Court in *RadLAX Gateway Hotel, LLC* ultimately followed.[91] Judge Ambro argued that both the structure of the Bankruptcy Code and

80. *Id.*
81. *Id.* at 302.
82. *Id.* at 319.
83. *Id.* at 302.
84. *Id.* at 304.
85. *Id.*
86. *Id.* at 307.
87. *Id.* at 315.
88. *Id.* at 334.
89. *Id.* at 303.
90. *Id.* at 317.
91. *See* RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065, 2069–70 (2012); *In re* River Rd. Partners, LLC, 651 F.3d 642, 649–50 (7th Cir. 2011).

public policy considerations support a different conclusion: that reorganization plans providing for the sale of collateral should be governed exclusively by the rules of Path Two, which requires that plans proposing to sell collateral free and clear of liens must permit secured lenders to credit bid at the sale.[92] After noting that the statute is ambiguous,[93] Judge Ambro argues that the structure of the Bankruptcy Code supports his reading of the statute by showing how § 1129(b)(2)(A) works in conjunction with related provisions. He maintains that § 1123, which governs the content of the plan, sets out "three ways in which a plan can provide for the sale of collateral: (i) subject to the initial lien retained by the secured creditor, (ii) free of any lien, or (iii) after providing a replacement lien on different collateral."[94] Judge Ambro then argues that these three paths correspond to, and help clarify, the three paths to approval under the cramdown provision.[95] While secured creditors whose collateral is sold under Path Two are protected by the credit-bidding requirements of § 363(k),[96] those who keep their collateral under a Path One plan are protected from the danger of undervaluation by § 1111(b),[97] which permits under-secured creditors to elect to have their deficiency claims treated as secured claims.[98] Together, these provisions make up "a comprehensive arrangement enacted by Congress to avoid the pitfalls of undervaluation . . . and thereby ensure that the rights of secured creditors are protected while maximizing the value of collateral to the estate."[99] Congress, according to Judge Ambro, "intended to preserve the presumptive right of a secured creditor under applicable state law to take the property to satisfy the debt."[100] Judge Ambro also advances a policy-based argument that is independent from the issue of congressional intent, arguing that the majority's interpretation of the cramdown provision undermines the benefits of secured credit.[101] The Bankruptcy Code, the dissent asserts, was not intended to deprive secured creditors of "the presumed benefits associated with secured lending."[102]

Judge Ambro also demonstrates that the interpretation of the majority and of the *Pacific Lumber Co.* court is inconsistent with the absolute priority rule. He points out that Philadelphia Newspaper's assets were sold to an entity controlled by the current management of the debtor business and owned largely by the debtor's equity holders at a price far lower than

92. *In re Phila. Newspapers, LLC*, 599 F.3d at 319 (Ambro, J., dissenting).
93. *Id.*
94. *Id.* at 332.
95. *Id.*
96. *Id.* at 334.
97. *Id.*
98. *Id.* at 333.
99. *Id.* at 334.
100. *Id.* at 331.
101. *Id.* at 337.
102. *Id.*

the amounts of the secured claims.[103] As a result, certain equity holders were able to retain control and ownership of the business, even though the secured creditors were not paid in full.[104]

Both the Seventh Circuit in *River Road Partners, LLC* and the Supreme Court in *RadLAX Gateway Hotel, LLC* rejected the reasoning of *In re Pacific Lumber Co.* and *In re Philadelphia Newspapers, LLC* and followed Judge Ambro's dissent.[105] The Seventh Circuit addressed a jointly administered bankruptcy case involving two LLCs that had obtained loans to finance the construction of hotels.[106] Both companies, River Road Hotel Partners, LLC and RadLAX Gateway Hotel, LLC, failed to complete their projects and ended up filing for bankruptcy under Chapter 11.[107] Each owed about $150 million on their loans, which were secured by liens, at the time of filing.[108] Both companies submitted reorganization plans that proposed to pay the secured parties the proceeds from the sale of substantially all of the debtors' assets, and each claimed to have procured offers of around $45 million.[109] Neither plan permitted the secured creditors to credit bid at these sales.[110] The bankruptcy court denied confirmation, and both the Seventh Circuit and Supreme Court affirmed its decision.[111] The Supreme Court noted, however, that while some lower courts—particularly the dissent in *Philadelphia Newspapers, LLC*—had addressed the policy-based merits of credit bidding,[112] its decision was based purely on what it took to be the plain meaning of the statute.[113]

The decisions in *Pacific Lumber Co.* and *Philadelphia Newspapers, LLC* appeared to give debtor businesses a way of satisfying their debts to secured creditors at discounted rates while still holding on to the creditors' collateral. Such an approach would be inconsistent with the absolute priority rule. This inconsistency is evident in the facts of *Philadelphia Newspapers, LLC*, where junior creditors and equity holders were essentially permitted to hold on to their collateral—by bidding at the sale—even though the secured creditors were not paid in full.[114] The court in *Philadelphia Newspapers, LLC* justified this departure from the absolute priority rule by arguing that the purpose of Chapter 11 is to strike a balance

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103. *Id.* at 302.
104. *Id.* at 301–02.
105. RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065, 2072 (2012); *In re* River Rd. Partners, LLC, 651 F.3d 642, 649 (7th Cir. 2011).
106. *In re River Rd. Partners, LLC*, 651 F.3d at 643–44.
107. *Id.* at 644.
108. *Id.*
109. *Id.* at 645.
110. *Id.*
111. RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065, 2069 (2012); *In re River Rd. Partners, LLC*, 651 F.3d at 653.
112. *RadLAX Gateway Hotel, LLC*, 132 S. Ct. at 2073.
113. *Id.*
114. *In re* Phila. Newspapers, LLC, 599 F.3d 298, 302 (3d Cir. 2010) (Ambro, J., dissenting).

between the interests of creditors and those of other constituencies affected by the firm's insolvency.[115] In *RadLAX Gateway Hotel, LLC*, the Supreme Court rejected this policy-based argument as simply inconsistent with the text of the statute, which the Court found to be unambiguous in its requirement that secured creditors be permitted to credit bid at the sale of their collateral.[116] In the Supreme Court's interpretation, the statute does not permit a plan of reorganization that provides for the sale of the secured creditor's collateral to forego the credit-bidding requirement of Path Two.[117]

B. The Secured Lender's Right to Maintain Its Lien Under § 1129(b)(2)(A)(ii)

In *In re River East Plaza, LLC*, the Seventh Circuit addressed a plan of reorganization that proposed to stretch out the repayment period, a procedure provided for by Path One, without adhering to other requirements of Path One.[118] The Seventh Circuit thus faced a parallel issue to the one faced by the Supreme Court in *RadLAX Gateway Hotel, LLC*. The cases culminating in *RadLAX Gateway Hotel, LLC* addressed plans that used a procedure that is provided for in Path Two—sale of collateral free and clear of liens—without adhering to the requirement of Path Two that secured creditors must be permitted to credit bid. Likewise, the Seventh Circuit in *River East Plaza, LLC* addressed a plan that used a procedure that is provided for in Path One—deferred payments—without adhering to the requirement of Path One that the holders of secured claims retain their liens.[119] As with the plans in the cases discussed above, the debtors argued that this plan satisfied the indubitable-equivalence standard of Path Three.[120] The Seventh Circuit, whose decision came down during the pendency of *RadLAX Gateway Hotel, LLC*, found that the plan did not satisfy the indubitable equivalent requirement of Path Three[121] and went on to argue in dicta that any plan that provided for deferred payments should be required to adhere to the requirements of Path One.[122]

The secured creditor in *River East Plaza, LLC* was LNV Corporation (LNV), a mortgagee who was owed $38.3 million by River East Plaza, the debtor/mortgagor.[123] The value of the property at the time of filing was $13.5 million.[124] After River East Plaza filed, LNV elected to have its

115. *Id.* at 303.
116. *RadLAX Gateway Hotel, LLC*, 132 S. Ct. at 2073.
117. *Id.* at 2072.
118. *In re* River E. Plaza, LLC, 669 F.3d 826, 833 (7th Cir. 2012).
119. *Id.*
120. *Id.* at 829.
121. *Id.* at 832.
122. *Id.* at 833.
123. *Id.* at 829.
124. *Id.*

under-secured claim treated as fully secured.[125] River East Plaza eventually proposed a plan in which it would replace LNV's lien on the property with a lien on $13.5 million in substitute collateral in the form of thirty-year treasury bonds.[126] It argued that this replacement lien satisfied the indubitable-equivalence standard of Path Three because "the bonds would grow in value in 30 years through the magic of compound interest to $38.3 million," thus eventually paying the secured creditor the full amount of the secured claim.[127] The bankruptcy court, as well as the Seventh Circuit, rejected the plan as failing to satisfy the indubitable-equivalence standard of Path Three.[128]

The court first argued that a lien on thirty-year treasury bonds was simply not the indubitable equivalent of a lien on the property in question, noting that thirty-year treasury bonds and real property have totally different risk profiles.[129] However, the court also reasoned that by paying off LNV in thirty-year treasury bonds, River East Plaza was effectively using a procedure provided for by Path One—stretching "out the repayment of the debt beyond the period allowed by the loan agreement"[130]—without adhering to the requirement of Path One that the secured creditor retain its lien on the collateral.[131] River East Plaza's plan did not permit LNV to retain its lien on the property, but rather replaced it with a lien on the thirty-year treasury bonds.[132] Thus, the court reasoned that River East Plaza "was in effect proposing a defective subsection (i) cramdown,"—defective because it did not permit LNV to retain its lien—"by way of subsection (iii)."[133]

It should be noted with regard to *River East Plaza, LLC* that the court simply held that the plan did not satisfy the indubitable equivalent requirement;[134] the question of whether or not any plan that stretched out payments as provided for in Path One could be approved under Path Three was not properly addressed by the court.[135] Judge Posner observed the parallel between *River East Plaza, LCC* and *River Road Partners, LCC*[136] and argued that any plan that provided for deferred payment should not be

125. *Id.* Under 11 U.S.C. § 1111(b) (2012), a secured creditor whose collateral is worth less than the total amount of its claim is permitted to elect to have its entire claim treated as a secured claim.
126. *In re River E. Plaza, LLC*, 669 F.3d at 830.
127. *Id.*
128. *Id.* at 830, 832.
129. *Id.* at 832.
130. *Id.* at 828, 833.
131. 11 U.S.C. § 1129(b)(2)(A)(i) (2012).
132. *In re River E. Plaza, LLC*, 669 F.3d at 830.
133. *Id.* at 833.
134. *Id.* at 832.
135. *See id.*
136. *Id.* at 829.

approved under Path Three,[137] but these observations were not part of the holding because the substitution of treasury bonds failed to meet the indubitable-equivalence standard anyway.[138]

However, the Supreme Court's interpretive approach in *RadLAX Gateway Hotel, LLC* suggests that it would validate Judge Posner's reasoning and reach the same conclusion regarding Path One as it did Path Two. The Supreme Court stated in *RadLAX Gateway Hotel, LLC* that "the '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)."[139] It would follow that since plans that provide for deferred payments are "specifically dealt with" in Path One, the rules of Path Three "will not be held to apply."[140]

Taken together, the holding of *RadLAX Gateway Hotel, LLC* and the abovementioned dicta of *River East Plaza, LLC* amount to a substantial limitation on the ability of bankruptcy courts to use the indubitable-equivalence standard as a means of cramming down plans of reorganization. *Pacific Lumber Co.* and *Philadelphia Newspapers, LLC* had opened up the possibility that bankruptcy courts might be able to use the flexible standard of Path Three to permit substantial modifications of the rights of secured creditors by allowing equity holders and managers to essentially purchase the business from secured creditors at a discount.[141] They exercised such discretion by requiring only that secured creditors receive the *value* of their collateral, as determined by the price produced at auction or by the court.[142] In contrast, the Supreme Court determined that for plans that proceed under Path Two, secured creditors are entitled not only to the value of the collateral, but also to the collateral itself if the highest bid at auction falls short of their secured claim.[143] By requiring all

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137. *Id.* at 833.

138. *Id.* at 832.

139. RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065, 2071 (2012) (quoting D. Ginsberg & Sons, Inc. v. Popkin, 285 U.S. 204, 208 (2012)).

140. *See RadLAX Gateway Hotel, LLC*, 132 S. Ct. at 2071.

141. For example, in *Philadelphia Newspapers, LLC*, the court permitted a bidder to purchase the assets of the business at a lower price than it would have paid if the secured lenders had been permitted to credit bid. *In re* Phila. Newspapers, LLC, 599 F.3d 298, 320 (3d Cir. 2010) (Ambro, J. Dissenting) ("What typically occurs is that, if there are no other bidders, the secured lenders get the assets rather than the Stalking Horse Bidder . . . . If credit bidding is denied, however, the debtors' insiders stand to benefit by having more leverage to steer the sale to a favored purchaser.").

142. Thus, for example, in *Pacific Lumber Co.*, the court was able to limit the amount of the Noteholder's secured claim to the court-determined value of the Timberlands at the time of the case. *In re* Pac. Lumber Co., 584 F.3d 229, 245 (5th Cir. 2009).

143. *RadLAX Gateway Hotel, LLC*, 132 S. Ct. at 2069. By requiring credit bidding for all reorganization plans that proceed under Path Two, the Court effectively permits secured creditors to seize their collateral any time the price produced at auction falls short of their secured claims. Thus the Supreme Court's decision ensures that secured creditors have an interest not only in the value of collateral as determined by an auction, but also in the collateral itself. Jonathan Azoff,

reorganization plans that provide for the sale of collateral to comply with the requirements of Path Two, the Supreme Court closed off this potential avenue of judicial discretion. In doing so, it reinforced the role of the three clauses of § 1129(b)(2)(A) as safeguards of the state law rights of secured creditors.

III. POLICY APPROACHES TO BANKRUPTCY LAW

Much of the commentary on these cases thus far has approved of the prevailing interpretation of § 1129(b)(2)(A) on the ground that it is the product of sound statutory interpretation.[144] Commenters argue that the interpretations of *Pacific Lumber Co.* and *Philadelphia Newspapers, LLC* render Path Two superfluous;[145] that the legislative history supports the interpretation of the Supreme Court;[146] that depriving secured creditors of their right to credit bid at sales of collateral contradicts the intention of Congress;[147] and that the overall structure of the Bankruptcy Code supports the Supreme Court's interpretation.[148] As this Note will demonstrate in Part IV, the prevailing interpretations of § 1129(b)(2)(A) are consistent with a policy approach to bankruptcy law known as the creditor's-bargain theory.[149] The language of the court in *Philadelphia Newspapers, LLC*, on the other hand, suggests an optimal-loss-distribution approach.[150] These theories help to illuminate what is at stake in the courts' competing interpretations, as well as the function that § 1129(b)(2)(A) plays in Chapter 11 proceedings.

A. THE CREDITOR'S-BARGAIN THEORY OF BANKRUPTCY LAW

Proponents of the creditor's-bargain approach to bankruptcy take as a foundational principle the following proposition: federal bankruptcy law is a means of solving the collective action problem that arises when a debtor

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Indubitable Equivalence: A Standard Designed to Protect the Secured Creditor's Bargain, 21 NORTON J. BANKR. L. & PRAC. 127, 140 (2012).

144. *See, e.g.*, Eric W. Chalut & Blair R. Zanzig, River Road*: The Right Road for Selling a Secured Lender's Collateral Under a Chapter 11 Plan*, 129 BANKING L.J. 173, 181–82 (2012); Ben Logan et al., *Seventh Circuit Takes the (River) Road Less Traveled, Creating a Circuit Split on the Issue of the Right to Credit Bid in a Sale Pursuant to a Chapter 11 Plan*, 7 PRATT'S J. BANKR. L. 708, 711 (2011).

145. Chalut & Zanzig, *supra* note 144, at 183.

146. *Id.* at 184.

147. *Id.* at 186.

148. *Id.* at 187.

149. *See infra* Part IV.

150. "Chapter 11 of the Bankruptcy Code strikes a balance between two principal interests: facilitating the reorganization and rehabilitation of the debtor as an economically viable entity, and protecting creditors' interests by maximizing the value of the bankruptcy estate." *In re* Phila. Newspapers, LLC, 599 F.3d 298, 303 (3d Cir. 2010). For more detailed summaries of these approaches, see Baird, *supra* note 5; Warren, *supra* note 5.

with more than one creditor goes into default.[151] In a world without bankruptcy, each of the creditors in such a situation would have an incentive to invoke state collection rights before other creditors in similar positions do the same.[152] However, engaging in a race to seize all of the debtor's assets may not be in the best interest of the creditors collectively.[153] Such a race would eliminate the excess of the going-concern value over the liquidation value.[154] Bankruptcy is an orderly process that ensures that the debtor's assets will be put to their most productive use, which may indeed turn out to be liquidation.[155] Thus, federal bankruptcy law can be justified as a contractual gap-filing measure—a system "designed to mirror the agreement one would expect . . . creditors to form among themselves were they able to negotiate such an agreement from an *ex ante* position."[156]

This reasoning, however, would not apply to creditors with security interests, who would otherwise be free to seize their collateral.[157] Proponents of the creditor's-bargain theory argue that general unsecured creditors, who have strong reasons for desiring a collective proceeding,[158] would have an incentive to bargain with secured creditors for such a proceeding.[159] Since secured creditors would have the right to seize their collateral and thereby destroy the debtor business' going-concern value, they would be in the stronger bargaining position and would not settle for anything less than what they bargained for outside of bankruptcy; that is, they would not settle for anything less than full priority in repayment.[160] Therefore, as one prominent advocate of the creditor's bargain theory argues, "there is nothing 'unfair' about recognizing a secured creditor's" full priority in bankruptcy; "[i]nstead, it is exactly the sort of agreement we would expect to see negotiated voluntarily" between secured and unsecured creditors.[161]

Bankruptcy law, according to proponents of this view, should only modify the state law hierarchy of repayment "when doing so preserves the value of assets for the group of investors holding rights in them."[162] Since general unsecured creditors have the most to gain from a collective

151. Jackson, *supra* note 5, at 861–62.
152. *Id.* at 862.
153. *Id.*
154. If the firm's assets are seized it cannot continue to operate its business, so any value that could be generated by a group of assets *functioning as a unit* would be eliminated. *See* GERBER & KUNEY, *supra* note 16, at 93–94.
155. Baird & Jackson, *supra* note 16, at 105–06.
156. Jackson, *supra* note 5, at 860.
157. *Id.* at 868.
158. *Id.*
159. *Id.*
160. Baird & Jackson, *supra* note 16, at 121.
161. Jackson, *supra* note 5, at 871.
162. Baird & Jackson, *supra* note 16, at 100.

proceeding, they, rather than creditors with security interests, should bear the risk of such proceedings.[163] A rule that distorted state law priorities by diminishing the rights of secured creditors would encourage forum shopping, giving equity holders and managers an incentive to enter into bankruptcy simply to take advantage of a different set of rules.[164]

Additionally, it is worth observing that most of the supporters of the creditor's bargain approach to bankruptcy make no comment on the utility or wisdom of the current regime of secured credit.[165] They do not favor the protection of secured creditors in bankruptcy because protecting secured creditors is always good policy.[166] Rather, they argue that the utility of affording maximum protection to secured creditors is simply not an issue of bankruptcy law; bankruptcy law should preserve state law rights to the extent feasible, regardless of what those rights happen to be.[167]

B. THE "DISTRIBUTIVE" APPROACH TO BANKRUPTCY POLICY

Another prominent approach to bankruptcy policy, which is evoked by the court in *Philadelphia Newspapers, LLC*, regards the Bankruptcy Code as a means of addressing a broad range of social problems that are the inevitable byproducts of business failure.[168] Advocates of this approach note that "the statutory scheme" of the Bankruptcy Code "presumes that some creditors will not enjoy repayment in full;"[169] in other words, losses are inevitable. They go on to ask: "How shall these losses be distributed?"[170] The bargains made by secured creditors outside of bankruptcy are just a few of the many interests that the Bankruptcy Code should protect.[171] The Bankruptcy Code should also protect the interests of individuals and businesses "who are not technically 'creditors' but who have an interest in a business' continued existence," such as employees, customers, and suppliers, as well as future tort claimants.[172]

Advocates of this view argue that optimal distribution of losses is more than a normative theory of how bankruptcy law should function; it is in fact how Congress intended the Bankruptcy Code to function:

> Congressional comments on the Bankruptcy Code . . . serve as reminders that Congress intended bankruptcy law to address concerns broader than the immediate problems of debtors and their identified creditors; they indicate clear recognition of the larger implications of a debtor's

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163. *Id.* at 129.
164. Baird, *supra* note 5, at 818.
165. Baird & Jackson, *supra* note 16, at 110.
166. *Id.* at 110–11.
167. *Id.*
168. *Id.* at 101.
169. Warren, *supra* note 5, at 785.
170. *Id.* at 777.
171. *Id.* at 787.
172. *Id.*

> widespread default and the consequences of permitting a few creditors to force a business to close.[173]

Thus, bankruptcy courts should sometimes be permitted to alter state law priorities to the extent necessary to reach equitable results.

IV. THE ROLE OF § 1129(b)(2)(A) IN PROTECTING THE SECURED CREDITOR'S BARGAIN

The limitations on cramdown provisions set out in the three clauses of § 1129(b)(2)(A)—Paths One, Two, and Three—indicate the extent to which Congress intended to protect the bargains made by secured creditors outside of bankruptcy.[174] Both the Fifth Circuit in *Pacific Lumber Co.* and the Third Circuit in *Philadelphia Newspapers, LLC* suggest that Congress intended to permit bankruptcy courts to use Path Three of § 1129(b)(2)(A) to modify state law priorities, at the expense of secured creditors, by using the indubitable-equivalence standard of Path Three as way of approving plans that appeared to proceed under different paths.[175] The *Philadelphia Newspapers, LLC* court evoked the distributive theory in its reasoning: "Chapter 11 of the Bankruptcy Code strikes a balance between two principal interests: facilitating the reorganization and rehabilitation of the debtor as an economically viable entity, and protecting creditors' interests by maximizing the value of the bankruptcy estate."[176] The interpretation of the Supreme Court, on the other hand, limits this discretion by prohibiting courts from using the indubitable-equivalence standard of Path Three for any plan that proceeds under Path One.[177] In doing so, it reinforced the protection of state law priorities in bankruptcy and therefore the bargains made by secured creditors outside of bankruptcy.

This is a sound result because the three clauses of § 1129(b)(2)(A) function as safeguards of the state law rights of secured creditors, not as means of altering state law priorities. In the implicit bargain between secured and unsecured creditors posited by creditor's-bargain advocates, secured creditors would consent to a collective bankruptcy proceeding as

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173. *Id.* at 788.

174. This is because these three clauses set out the only circumstances under which a secured creditor may be forced to accept less than full repayment of its secured claim. 11 U.S.C. § 362(a) (2012). The stricter the limitations on approval of such a plan, the more the Code protects secured creditors.

175. *In re* Phila. Newspapers, LLC, 599 F.3d 298, 305 (3d Cir. 2010) ("The use of the word 'or' in this provision operates to provide alternatives—a debtor may proceed under subsection (i), (ii), *or* (iii), and need not satisfy more than one subsection."); *In re* Pac. Lumber Co., 584 F.3d 229, 246 (5th Cir. 2009) (quoting 11 U.S.C. § 1129(b)(2)(A)(iii)) ("Although a credit bid option might render Clause (ii) imperative in some cases, it is unnecessary here because the plan offered a cash payment to the Noteholders. Clause (iii) thus affords a distinct basis for confirming a plan if it offered the Noteholders the 'realization . . . of the indubitable equivalent of such claims.'").

176. *In re Phila. Newspapers, LLC*, 599 F.3d at 303.

177. RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065, 2073 (2012).

long as the unsecured creditors were willing to bear the risk.[178] Creditors whose loans are bifurcated into secured and unsecured claims would in fact prefer such a proceeding because it would likely result in a greater return on the unsecured portion of their debt.[179] Such creditors would consent, therefore, to the temporary suspension of their contract rights that facilitate a collective proceeding.[180] However, since outside of bankruptcy they would have been able to seize their collateral, secured creditors would have no reason to consent to less than full priority in repayment.[181] From this perspective, § 1129, which governs the standards a plan of reorganization must meet in order to be confirmed, should afford maximum protection to secured creditors because these creditors would presumably bargain for robust protections.

The strict requirements of Paths One and Two of § 1129(b)(2)(A) indicate that Path Three should function as a protection of the bargains of secured creditors. Secured creditors who are forced into Path One—deferred payments—are ensured the benefit of their bargain in two ways: by the requirements that they retain their liens[182] and be permitted to elect under § 1111(b) to have their claims treated as fully secured.[183] Secured creditors forced into Path Two—sale of collateral—are ensured the benefit of their bargain by the requirement that they be permitted to credit bid at the sale of their collateral.[184] Both of these paths protect more than the secured creditor's interest in the value of its collateral at the time the plan is submitted; they protect the secured creditor's interest in the actual collateral for which it bargained, which would otherwise be protected under non-bankruptcy law.[185]

The rationale for requiring credit bidding at sales of collateral is to ensure that a secured creditor's interest will not be under-valued, either at an auction or by the court,[186] and thus to ensure that the secured creditor will not be any worse off in bankruptcy than it would be outside of bankruptcy. The secured creditor in *Philadelphia Newspapers, LLC* bargained for a lien on the personal property of Philadelphia Newspapers, LLC, *not* for a guarantee of the value that the property would produce at a bankruptcy auction.[187] There are two problems with transferring the secured

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178. Jackson, *supra* note 5, at 868.

179. Upon the bankruptcy filing, the claims of creditors with security interests in assets that are worth less than their claims are bifurcated into "allowed secured claims" and unsecured claims. 11 U.S.C. § 506; *see also* WARREN, *supra* note 6, at 46–49.

180. For a discussion of the benefits of the bankruptcy process for both secured and unsecured creditors, see Jackson, *supra* note 5, at 858–72.

181. Baird & Jackson, *supra* note 16, at 106.

182. 11 U.S.C. § 1129(b)(2)(A)(i).

183. *Id.* § 1111(b).

184. *Id.* § 1129(b)(2)(A)(ii).

185. Azoff, *supra* note 143, at 140.

186. *In re* Phila. Newspapers, LLC, 599 F.3d 298, 332 (3d Cir. 2010) (Ambro, J. Dissenting).

187. *Id.* at 301.

creditor's lien from the property itself to the proceeds from the sale of the property. First, the highest bids at bankruptcy auctions typically fall well below the fair value of the property,[188] as was the case in *Philadelphia Newspapers, LLC*.[189] Likewise, bankruptcy judges may undervalue collateral to the detriment of secured creditors, as was the case in *Pacific Lumber Co.*[190] Second, the value of property, real property in particular, fluctuates over time; if collateral is sold while the market is down, secured parties will suffer losses. As the dissent argues in *Philadelphia Newspapers, LLC*, the right to credit bid is meant to protect secured creditors from the danger of undervaluation.[191] It also prevents junior creditors from engaging in maneuvers, such as those engaged in by the equity holders in *Philadelphia Newspapers, LLC*, which effectively permit them to benefit at the expense of senior creditors.

Likewise, the indubitable-equivalence standard of Path Three is best understood not as a grant of discretion to the court, but rather as a safeguard of the bargains made under state law by secured creditors.[192] Commenters have observed that the standard articulated in *Murel* is a demanding one, and that "Judge Hand framed indubitable equivalence in reference to the creditor's expectations."[193] Courts have also observed that "the 'fair and equitable' requirement does not look toward protection of debtor interests, but rather toward protection of dissenting creditor interests."[194]

Thus, the "fair and equitable" standard is best understood as an application of the absolute priority rule, not an exception to it. The courts in *Pacific Lumber Co.* and *Philadelphia Newspapers, LLC* use the indubitable-equivalence standard as a means of altering state law priority of payment in order to balance the interests of all of the parties involved.[195] The result is that junior creditors have an incentive to use bankruptcy simply as a means of taking a larger slice of the repayment pie than they would have taken outside of bankruptcy, and equity holders have an incentive to use bankruptcy simply as a means of retaining control of a company at a discounted price. This incentive structure is likely to prevent the firm's assets from being put to their highest value use.[196] As Baird and Jackson

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188. Leonard P. Goldberger & Harvey L. Tepner, *A Guide for Acquiring Businesses in Bankruptcy*, 10 J. BANKR. L. & PRAC. 521, 522 (2001).

189. *In re Phila. Newspapers, LLC*, 599 F.3d at 332.

190. *In re* Pac. Lumber Co., 584 F.3d 229, 248 (5th Cir. 2009).

191. *In re Phila. Newspapers, LLC*, 599 F.3d at 332.

192. Azoff, *supra* note 143, at 140.

193. *Id.* at 133.

194. *In re* Koelbl, 751 F.2d 137, 140 (2d Cir. 1984).

195. *See, e.g.*, *In re Phila. Newspapers, LLC*, 599 F.3d at 303 ("Chapter 11 of the Bankruptcy Code strikes a balance between two principal interests: facilitating the reorganization and rehabilitation of the debtor as an economically viable entity, and protecting creditors' interests by maximizing the value of the bankruptcy estate.").

196. Baird & Jackson, *supra* note 16, at 109.

warn, junior parties will "systematically make decisions that ignore the real costs of keeping the firm together."[197]

The facts of *Philadelphia Newspapers, LLC* provide a useful illustration of the adverse effects of using the indubitable-equivalence standard of Path Three to alter state law priorities in Chapter 11 bankruptcy proceedings. In that case the court approved a plan of reorganization that proposed to sell the secured creditor's collateral without permitting the secured creditor to credit bid and to use the proceeds from the sale as the "indubitable equivalent" of the collateral.[198] As the dissent notes, Philadelphia Newspapers, LLC's assets were sold to an entity controlled by the current management of the debtor business and owned largely by the debtor's equity holders[199] at a price that was a fraction of the secured claim.[200] The dissent also notes that "the debtor's strategies were designed 'not to produce the highest and best offer.'"[201] In other words, the debtor's insiders were able to purchase substantially all of the assets of the company, free and clear of liens, at a price much lower than the creditors' secured claim. Junior creditors (the current equity holders) benefitted at the expense of senior creditors (the secured lenders). Such a result gives equity holders an incentive to enter into bankruptcy simply to take advantage of a different set of rules.

CONCLUSION

The three cramdown paths of § 1129(b)(2)(A) were designed to ensure secured creditors the benefits of their state law bargains; accordingly, protection of the state law priority of secured creditors should be the guiding policy consideration for courts interpreting this subparagraph. This is not to say that the enhancement of the collection efforts of secured creditors is or should be the objective of every provision in the Bankruptcy Code. The procedural rules that facilitate a collective bankruptcy proceeding are designed to further the interests of the firm, and thereby those of other constituencies that would benefit from the firm's survival, such employees and suppliers, at the temporary expense of secured creditors. However, the rules governing the substance of the plan of repayment, of which § 1129(b)(2)(A) is one, should not give preferential treatment to parties that would not enjoy such treatment outside of bankruptcy. While the "debtor in process of reorganization . . . is given

197. *Id.* at 110.
198. *In re Phila. Newspapers, LLC*, 599 F.3d at 302.
199. *Id.* at 319.
200. *Id.* at 302.
201. *Id.* at 319 (quoting *In re* Phila. Newspapers, LLC, No. 09–11204, 2009 WL 3242292, at *10 (Bankr. E.D. Pa. Oct. 8, 2009)).

many temporary protections against the normal operation of law . . . , the reorganized debtor is supposed to stand on his own two feet."[202]

Brian P. Hanley[*]

202. United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., LTD., 484 U.S. 365, 378 (1987).

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