

CREDIT BIDDING AND THE DESIGN OF BANKRUPTCY AUCTIONS

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INTRODUCTION

Chapter 11 filings are commonly referred to as reorganizations.¹ But most recent, large-scale Chapter 11s do not comfortably wear that label. Gone are the days of the financially distressed railroads, the assets of which—primarily long stretches of track—were too valuable conjoined to be sold piecemeal, and yet too expensive for capital-constrained buyers to purchase *in toto*. Today, some 56 percent of debtors with any value to speak of essentially sell all of their assets.² Even in bankruptcies where an economically viable firm needs rescue from a debt-laden balance sheet, there is little reason to believe—in an era when multibillion-dollar financings are ho-hum—that an arm’s length buyer will be unable to locate the capital to purchase the entire firm.³

In high-stakes cases, bankruptcy judges now serve primarily as auctioneers. The question remains how they should structure the auctions over which they preside.⁴ When answering that query, courts ought to pay heed to an overarching and, we hope, uncontroversial premise: the principal object of every bankruptcy is to maximize recoveries to the debtor’s claimants.⁵ A logical corollary to this foundational rule is that the goal of every bankruptcy sale is to attract the highest price for the debtor’s assets while

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¹ *E.g.*, Nevin M. Gewertz, Comment, *Act or Asset? Multiplicitous Indictments Under the Bankruptcy Fraud Statute*, 18 USC § 152, 76 U. CHI. L. REV. 909, 929 (2009).

² Douglas G. Baird & Robert K. Rasmussen, Reply, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675-76 (2003) (finding that 56 percent of Chapter 11 proceedings in 2002 involved sales of assets).

³ *See, e.g.*, Bay Harbour Mgmt., L.C. v. Lehman Bros. Holdings Inc. (*In re Lehman Bros. Holdings, Inc.*), 415 B.R. 77, 80, 86 (Bankr. S.D.N.Y. 2009) (affirming the sale of virtually all of Lehman Brothers’ assets to Barclays Capital for \$1.7 billion); Baird & Rasmussen, *supra* note 2, at 676 (describing how Berkshire Hathaway bought Fruit of the Loom for \$800 million after Fruit of the Loom filed for Chapter 11).

⁴ Douglas G. Baird, Car Trouble 2 (May 7, 2010) (unpublished manuscript), available at https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=ALEA2010&paper_id=9.

⁵ *See, e.g.*, Toibb v. Radloff, 501 U.S. 157, 163 (1991) (stating that the general policy of the Bankruptcy Code is to “maximiz[e] the value of the bankruptcy estate”).

minimizing the transaction costs associated with the auction.⁶ Against the backdrop of prevailing bankruptcy practice, credit bidding, we argue, stands out as an especially effective tool to achieve those twin aims.

Credit bidding permits a secured creditor to bid up to the face value of its loan as consideration for the assets a bankrupt debtor proposes to sell.⁷ It is a tool well-calibrated to maximize the value of a bankruptcy estate for several reasons. First, credit bidding increases the often small pool of bidders sufficiently familiar with the debtor's assets to buy them on a truncated timetable.⁸ Second, it constrains debtors from favoring "white knight"⁹ buyers who do not offer the highest purchase price. Third, credit bidding reduces the cost to submit a bid and minimizes transaction costs in general.¹⁰ As we show in Part IV, encouraging potential bidders to become actual bidders is an unmitigated good for an estate. All of this is but to say that credit bidding should augment, and cannot depress, the net recovery to the debtor's creditors—and this on no small scale. Given the number of large, complex bankruptcy sales, the decision whether to authorize credit bidding likely holds tens of billions of dollars in the balance.

Until very recently, the value inherent in credit bidding was not in jeopardy, as bankruptcy courts had virtually no authority to enjoin the practice.¹¹ Most debtors have elected to pursue bankruptcy sales through § 363 of the Bankruptcy Code, which textually assures the right to credit bid save "for cause."¹² Yet a debtor minded to circumvent the credit-bidding guaran-

⁶ See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182, 185 (Del. 1986) (holding that the directors of Revlon's board had a duty to maximize shareholder profit at a bankruptcy sale).

⁷ See *Freedom Mortg. Corp. v. Burnham Mortg., Inc.*, 569 F.3d 667, 670 (7th Cir. 2009).

⁸ See generally *United Food & Commercial Workers Union, Local 211 v. Family Snacks, Inc. (In re Family Snacks, Inc.)*, 257 B.R. 884, 897 (B.A.P. 8th Cir. 2001) (stating that asset sales usually occur on an "expedited basis"); Robert E. Steinberg, *The Seven Deadly Sins in § 363 Sales*, AM. BANKR. INST. J., June 2005, at 22, 22 (describing how a sale may occur within two or three months after the initial bankruptcy filing).

⁹ *Gandal v. Telemundo Grp., Inc.*, 997 F.2d 1561, 1562 (D.C. Cir. 1993) (internal quotation marks omitted) (describing a "white knight" as a buyer sought after to maximize shareholders' value (internal quotation marks omitted)); *Dynamics Corp. of Am. v. CTS Corp.*, 805 F.2d 705, 711 (7th Cir. 1986) (defining a "white knight" as "a buyer acceptable to the board" (internal quotation marks omitted)).

¹⁰ Baird, *supra* note 4 (manuscript at 15) (stating that credit bidding enables secured creditors to bid up to the amount of their claim and avoid the transaction costs of obtaining a day loan).

¹¹ See, e.g., *John Hancock Mut. Life Ins. Co. v. Cal. Hancock, Inc. (In re Cal. Hancock, Inc.)*, 88 B.R. 226, 230-31 (B.A.P. 9th Cir. 1988) (holding that a nonrecourse creditor has the right to credit bid in a sale pursuant to a reorganization plan); *In re 222 Liberty Assocs.*, 108 B.R. 971, 978 (Bankr. E.D. Pa. 1990) (stating that the Bankruptcy Code protects the creditor for the full amount of its claim through the right to credit bid at sale); *In re Woodridge N. Apts., Ltd.*, 71 B.R. 189, 190 (Bankr. N.D. Cal. 1987) (holding that the "sale exception" to 11 U.S.C. § 1111(b)(1)(A) does not apply to a sale that forbids credit bidding (internal quotation marks omitted)).

¹² 11 U.S.C. § 363(k) (2006).

tee of § 363 has another statutory avenue to effect a sale of substantially all of its assets: a plan of reorganization under § 1129.¹³ To approve an 1129 sale over the objection of secured creditors who wish to credit bid, the debtor must provide the “indubitable equivalent”¹⁴ of their secured claims as part of a plan that is “fair and equitable.”¹⁵ By its terms, the text of § 1129 does not expressly afford secured creditors the right to credit bid for their collateral.

Latching onto the textual distinction between § 363 and § 1129, two recent bankruptcy decisions concluded that secured creditors do not have the right to credit bid in sales pursuant to § 1129. *In re Pacific Lumber Co.*¹⁶ and *In re Philadelphia Newspapers, LLC*¹⁷ both invoked the supposedly plain meaning of the statutory provision, as juxtaposed with the text of § 363, to prohibit secured creditors with a security interest in substantially all of the debtors’ assets from bidding on credit.¹⁸ The upshot of these decisions is that every would-be buyer of a debtor’s assets must come to the auction house with cash.¹⁹ The potential ramifications of these path-marking opinions have sent shockwaves through the bankruptcy and distressed-investing communities. Debtors now retain an easy statutory tool to prevent an auction procedure that can benefit a debtor’s claimants yet do the debtors no harm. If a debtor wishes to prohibit credit bidding, it can simply initiate a sale under § 1129 rather than—as it typically would have in years past—§ 363.²⁰ In each case standing alone, the decision to prohibit credit bidding was a several-hundred-million-dollar mistake. If the logic of *Pacific Lumber* and *Philadelphia Newspapers* persuades other courts to disallow credit bidding, the decisions will prove even more costly.

This Essay contends that *Pacific Lumber* and *Philadelphia Newspapers* were wrongly decided as a matter of both law and policy. The text of § 1129 does not compel credit bidding, as those decisions correctly saw; but neither does it forbid it, leaving the matter to the sound discretion of the bankruptcy court. We argue that because credit bidding can only maximize the value of the estate where a creditor class holds a security interest in all

¹³ *Id.* § 1129.

¹⁴ *Id.* § 1129(b)(2)(A)(iii).

¹⁵ *Id.* § 1129(b)(1).

¹⁶ 584 F.3d 229 (5th Cir. 2009).

¹⁷ 599 F.3d 298 (3d Cir. 2010).

¹⁸ *Id.* at 309-11; *Pac. Lumber*, 584 F.3d at 245-47.

¹⁹ *Phila. Newspapers*, 599 F.3d at 301-02 (affirming the district court’s approval of bid procedures that required all qualified bidders to fund any purchase with cash); *Pac. Lumber*, 584 F.3d at 246 (stating that the option to credit bid was unnecessary when the reorganization plan offered a cash payment to the claimants).

²⁰ See *Phila. Newspapers*, 599 F.3d at 319 (Ambro, J., dissenting) (“Although few in the first 30 years of Bankruptcy Code jurisprudence read it that way, the majority today holds that 11 U.S.C. § 1129(b)(2)(A)(ii) is not the exclusive method through which a debtor can cram down a plan calling for the sale of collateral free of liens.”).

of a debtor's assets that are up for sale, it should always amount to an abuse of discretion for a bankruptcy court to forbid the procedure in those situations.

Part I of this Essay briefly reviews the economic rationale behind credit bidding. Part II succinctly canvasses the two provisions of the Code, § 363 and § 1129, which empower a debtor to sell assets in bankruptcy. Part III recounts the facts and holdings in *Pacific Lumber* and *Philadelphia Newspapers*. Part IV demonstrates that the text of § 1129, by itself or viewed alongside § 363, is compatible with credit bidding, while sound bankruptcy policy limits a court's discretion to bar the procedure in most cases.

I. CREDIT BIDDING OVERVIEW

Aptly named, credit bidding involves a secured creditor bidding for a debtor's assets with credit. The debtor owes the creditor a specified sum of money—the credit—and the creditor seeks to buy the asset by extinguishing some or all of that outstanding liability. Ignoring transaction costs, a winning credit bid should exactly match the results that would obtain if the secured creditor bid entirely with cash. To see that this is so, suppose a debtor owes its lone creditor \$1,000 secured by the debtor's only asset, which the debtor intends to sell at auction. Under cash-basis bidding, the creditor could borrow \$1,000 cash from the Bank and bid it on the asset. Assuming \$1,000 were the winning bid, the creditor would remit the borrowed funds to the debtor while the debtor would transfer its asset to the creditor. The debtor would then tender \$1,000 to the creditor as repayment for the secured loan (after all, the creditor's collateral sold for \$1,000, and as a secured party, he is entitled to the proceeds of the sale). The creditor would then repay the short-lived \$1,000 loan to the Bank. Netting out the transactions, the creditor retains the asset without a corresponding liability, while the debtor discharges his obligation to the creditor. The logic of credit bidding is that it avoids such senseless shuffling of funds from the Bank to the creditor to the debtor to the creditor back to the Bank. If the asset is worth less than the face amount of the creditor's secured claim, the creditor should be able to purchase it entirely with credit.

That intuitive result comports with the nature of the creditor's property interest. As a secured party, the creditor is not in the position of a mere obligee, relying on the debtor's promise to repay the \$1,000 it borrowed. The creditor instead retains a security interest, which is "an interest in [the debtor's asset] which secures payment or performance of [the debtor's] obligation."²¹ In essence, the creditor's property interest assures either that the debtor will repay in full or that the creditor may sell his collateral and

²¹ U.C.C. § 1-201(b)(35) (2006).

retain the proceeds up to the full amount of his claim.²² Put differently, where the debtor's asset is worth less than the face amount of the creditor's claim—\$1,000 in our hypothetical—the creditor owns the asset outright.²³ Though bankruptcy prohibits the creditor from exercising some of its property rights,²⁴ it does not frustrate the creditor's ownership in the property itself.²⁵ Credit bidding can therefore be recast as simply a logical recognition of the creditor's property interest.²⁶ By enabling a creditor to bid up to the face amount of his claim in a bankruptcy sale, credit bidding assures merely that the creditor need not pay himself cash for his own property.

Of course, the example above is highly stylized, and ever more complex iterations of the hypothetical are possible. Yet the basic ground rule for all manner of credit bidding is the same: the procedure should mimic the results of an all-cash transaction. To confirm the point with a slightly more complicated twist on the prior illustration, suppose the debtor owes secured creditors X and Y \$1,000 each, with the loans secured by the debtor's only asset. As above, the debtor proposes to sell its property at auction. If only X cares to bid \$1,000 on the asset, can he bid with credit, and if so, how much? The answers are yes and \$500. If X's \$1,000 winning bid were all cash, X would receive the asset and \$500, while Y would receive \$500.²⁷ X's net cash outlay would therefore be \$500. It follows that X should be able to bid \$1,000 for the debtor's asset with \$500 cash and \$500 credit. Or stated more generically, if X holds 50 percent of the total tranche of secured debt, X's bid can be composed of at most 50 percent credit. The rest of X's bid must come in cash. As above, this result respects X's property interest in the collateral. As one of two secured creditors with identical claims, X retains a 50 percent property interest in the debtor's asset. X should not have to pay himself for his own stake, but to own the asset outright, he must buy out Y's 50 percent share. A blended bid of 50 percent cash and 50 percent credit accomplishes precisely that.

²² *Phila. Newspapers*, 599 F.3d at 331 (Ambro, J., dissenting).

²³ For those familiar with derivatives, a secured creditor's economic interest can be expressed in terms of an option strategy. The holder of a security interest is simultaneously long a call option on the value of the collateral with a strike price of zero and short a call on the value of the collateral with a strike price equal to the face amount of the loan.

²⁴ For instance, the automatic stay prevents the creditor from repossessing his collateral. See 11 U.S.C. § 362 (2006).

²⁵ See Bruce H. White & William L. Medford, *A Secured Creditor's Rights to Intellectual Property Licensed by a Debtor in Bankruptcy*, AM. BANKR. INST. J., May 2001, at 24, 24 (stating that a security interest is equal to a property interest and the termination of an automatic stay does not eradicate this property interest).

²⁶ See Steinberg, *supra* note 8, at 22 (defining credit bidding as "tak[ing] an ownership interest in the company by bidding a reduction in the debt the company owes").

²⁷ X and Y are each owed \$1,000, for a total debt of \$2,000. That entitles each of them to \$1,000/\$2,000 or 50% of the proceeds from any winning bid of \$2,000 or less. Thus, if the asset sells for \$1,000, X and Y are each entitled to \$500.

The rules and intuition governing our simple hypotheticals can be expressed more generally. Suppose a debtor owes D to its single class of creditors. If a non-creditor wins an auction for the debtor's assets, he pays the estate P in cash. The creditors' recovery is expressed by $\min\{D, P\}$; that is, the creditors receive the full face amount of their debt D if $P > D$, with the residual $P - D$ paid to the shareholders, and the entire purchase price P if $P < D$, with nothing left over for the shareholders. Consider now any one creditor in the class that holds α percent of the debtor's total debt D . That creditor's recovery is $\min\{\alpha D, \alpha P\}$, while the other creditors share $\min\{(1 - \alpha)D, (1 - \alpha)P\}$. If $P > D$, the α creditor recovers αD , the other creditors receive $(1 - \alpha)D$, and the shareholders still receive $P - D$. Where $P < D$, the α creditor is entitled to αP , the remaining creditors divide $(1 - \alpha)P$, and the shareholders receive nothing.²⁸

Credit bidding simply authorizes creditors to bid their respective recoveries along with any residual amount in cash. The justification for the procedure is that all of a debtor's claimants, in all states of the world, should be indifferent among receiving their share of the sale proceeds from an outside bidder, from the creditor class as a whole, or from the credit-bidding α creditor.²⁹ Shareholders should be content to allow credit bidding because they receive $P - D$ in cash whenever $P > D$, just as they would if an outside bidder paid P in cash. If $P > D$ and the credit-bidding creditor class buys the assets, it pays D with credit and $P - D$ (the shareholder recovery) in cash. Similarly, shareholders and non-bidding creditors should not be averse to an α credit bidder because they receive $P - D$ and $(1 - \alpha)D$, their respective cash shares whenever $P > D$. The α credit bidder pays αD on credit (the amount it is entitled to where $P > D$) and $P - \alpha D$ in cash, of which $P - D$ goes to shareholders and $(1 - \alpha)D$ to the other creditors [$P - \alpha D = P - D + D - \alpha D = (P - D) + (1 - \alpha)D$]. If $P \leq D$, the credit-bidding class would pay P entirely on credit to purchase the assets. The shareholders receive no recovery, just as they would if an outside bidder paid cash. An α credit bidder pays αP on credit and $P - \alpha P$ or, factoring out the P , $(1 - \alpha)P$ in cash to the remaining creditors. Because the cash recoveries to the non-credit bidding parties precisely match the cash recoveries they would receive if the assets were sold to an outsider, credit and cash bidding should be treated identically. Said differently, bankruptcy courts should treat the credit portion of a creditor's bid the same as cash.

²⁸ Although this Essay focuses on credit bidding as a right that the Bankruptcy Code affords to secured creditors, our model illustrates that the economic principles justifying credit bidding apply to general creditors as well.

²⁹ See generally *In re Phila. Newspapers, LLC*, 599 F.3d 298, 332-33 (3d Cir. 2010) (Ambro, J., dissenting) (stating that the purpose of credit bidding is to maximize recovery at sale by protecting creditors from an undervaluation of assets sold).

II. CREDIT BIDDING UNDER THE BANKRUPTCY CODE

Corporate debtors wanting to sell themselves after filing for bankruptcy protection have two statutory routes (apart from a Chapter 7 liquidation): an asset sale under § 363, which governs the extraordinary use of property during the administration of a bankruptcy case,³⁰ and confirmation, under § 1129, of a plan that contemplates an auction as the means of reorganization.³¹ Because the debtor can accomplish the same end through either means, one naturally wonders why it would prefer to try to confirm a plan, languishing in bankruptcy as its assets deplete day by day, over a quick asset sale. The short answer is that the text of § 1129 differs from that of § 363. The debtor may perceive a legal advantage to auctioning itself through a plan of reorganization that offsets the cost of delay. One major difference between the sections is the textual treatment of credit bidding. This Part briefly describes each provision.

A. *Administrative Powers Under § 363: Use, Sale, and Lease of Property*

In recent years, debtors have increasingly used § 363 of the Bankruptcy Code to effect asset sales within Chapter 11.³² This section permits a trustee, and therefore a debtor-in-possession, to “use, sell, or lease, other than in the ordinary course of business, property of the estate.”³³ Aside from the other benefits that bankruptcy can provide, such sales have the advantage of allowing the debtor to sell its assets free and clear of liens.³⁴ In a typical case, the debtor enters Chapter 11, takes advantage of Code provisions that protect the company while it readies itself for sale,³⁵ and then conducts an auction under § 363.

One of the restrictions the Code imposes on § 363 sales, however, is the requirement that secured creditors be able to credit bid.³⁶ Section 363(k) provides:

³⁰ 11 U.S.C. § 363 (2006).

³¹ *Id.* § 1129.

³² *E.g.*, *Contrarian Funds LLC v. Aretex LLC (In re WestPoint Stevens, Inc.)*, 600 F.3d 231, 236-37 (2d Cir. 2010); *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 453 (3d Cir. 2006); *United Food & Commercial Workers Union, Local 211 v. Family Snacks, Inc. (In re Family Snacks, Inc.)*, 257 B.R. 884, 887 (B.A.P. 8th Cir. 2001).

³³ 11 U.S.C. § 363(b)(1).

³⁴ *See id.* § 363(f).

³⁵ *See id.* § 362(a)(1)-(8).

³⁶ *Id.* § 363(k). A “secured claim,” it is important to recall, is not the same as the face value of debt owed to a secured creditor; the debt is secured only to the extent of the value of the collateral. *See id.* § 506(a)(1) (“An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest

At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.³⁷

This provision tends to increase the value of the estate by increasing the number of knowledgeable bidders with quick access to credit-based currency that is equivalent to cash, as Part I shows. As we demonstrate in detail in Part IV, more bidders means a higher selling price or, in other words, a greater recovery for the debtor's claimants.

An "undersecured" creditor³⁸ has bifurcated claims, part secured and part unsecured, and the text of § 363 guarantees only the right to bid the secured portion.³⁹ Bifurcation creates an apparent circularity because one of the functions of a bankruptcy sale is to determine the value of the collateral, which is to say the secured claim, and yet the extent of the secured claim must be a preexisting, known quantity if it is to limit the amount of credit that can be bid at auction.⁴⁰ The only answer is to say that § 506,⁴¹ which governs bifurcated claims, permits the court to estimate the collateral's value, fixing the extent of the secured claim by judicial valuation.⁴² Recognizing, however, that the best way to measure the value of the collateral is through auction itself, courts have interpreted § 363 to permit credit bidding of the entire face value of a secured creditor's credit, notwithstanding a preexisting estimate.⁴³

The better-reasoned legal position is that, although the Code's text does not assure a creditor the right to bid the full face value of its credit, it

in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.").

³⁷ *Id.* § 363(k).

³⁸ An undersecured creditor is one whose claim is worth more than the value of the collateral. Rosemary Williams, Annotation, *Special Commentary: Bifurcation and Avoidance, or "Stripping," of Liens, Security Interests, and Encumbrances Held by Undersecured Creditors by Rehabilitating and Liquidating Debtors in Bankruptcy*, 158 A.L.R. FED. 1, 32 (1999).

³⁹ 11 U.S.C. § 363(k).

⁴⁰ See generally 9 COLLIER ON BANKRUPTCY ¶ 3012.01, at 3012-3 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2010) ("In order to determine the value of a secured claim, the court must determine the value of the collateral securing the claim.").

⁴¹ 11 U.S.C. § 506.

⁴² *Id.* § 506(a)(1); see also Rosemary Williams, Annotation, *Time and Method of Valuation Under 11 USCS § 506, of Security Held by Creditor of Bankruptcy Estate*, 134 A.L.R. FED. 439, 452-53, 479-80 (1996).

⁴³ E.g., *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 459 (3d Cir. 2006) (explaining that § 363(k) "empowers creditors to bid the total *face* value of their claims"). Although in our view the Code's text is explicit that an undersecured creditor need only be allowed to bid the value of its secured claim, the *SubMicron* decision rests on sound economic theory. Judicial valuation should be reserved for *bona fide* reorganizations and sales where secured creditors do not have a security interest in all of the assets on the block and hence cannot claim priority over any going-concern value.

would be an abuse of discretion for a judge to value a claim under § 506 beneath the price set in a market-based auction.⁴⁴ Thus, pre-auction judicial valuation is acceptable (necessary, in fact) for a true restructuring or an auction where the creditors are not entitled to any going-concern value generated by the sale. In those situations, the credit bidder will be limited to bidding the judicial valuation of its claim. Arguably, where the credit bidder holds a security interest in all of the assets up for sale, the judge should value the collateral by the sale itself and thus would have no discretion to inhibit the credit bidder from bidding the full face amount of its debt.

Despite the advantages of credit bidding, a debtor may nevertheless prefer an auction in which bidders must come to the table with cash in hand. The debtor might have a preferred buyer in mind, a buyer who, for example, plans to use the assets sympathetically to the cause of the debtor's own management. Think of a prospective buyer who wants to keep the assets together as a going concern rather than break them up and sell the parts. It could be that the assets do not realize their highest value in the hands of such a "white knight," and yet some of the debtor's stakeholders—perhaps especially the management that proposes the asset sale—could benefit. The problem is a standard one of agency: owners want their assets put to the highest value; managers want to ensure their compensation. Aligning these interests is particularly difficult in the context of a bankruptcy because the dissolution of assets—which may well maximize the debtor's value—inevitably means unemployment for the managers.

B. *Reorganization Under § 1129: Confirmation of the Plan*

For debtors hoping to avoid credit bids, there is an alternative to a § 363 sale. The debtor can propose to sell all of its assets under a plan of reorganization—under, that is, a plan confirmed by the bankruptcy court pursuant to 11 U.S.C. § 1129.⁴⁵ The requirements of § 363 do not apply to such a plan,⁴⁶ at least not directly, so a debtor may be able to avoid the credit-bid restriction if it can convince the bankruptcy court to confirm an auction plan that bars credit bidding.

Typically, of course, the bankruptcy court will not confirm a plan unless each class of claimant accepts it or the plan pays each objecting class

⁴⁴ See generally *Highland Fed. Bank v. Maynard (In re Maynard)*, 264 B.R. 209, 213 (B.A.P. 9th Cir. 2001).

⁴⁵ Any doubt that the heart of a plan of reorganization can be an asset sale is dispelled by 11 U.S.C. § 1123(a)(5)(D), which authorizes the "sale of all or any part of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate."

⁴⁶ See *In re Smurfit-Stone Container Corp.*, No. 09-10235 (BLS), 2010 WL 2403793, slip op. at *10 (Bankr. D. Del. June 11, 2010).

everything owed, whether or not the class agrees.⁴⁷ An auction plan to which no class objects poses no problem, whether or not the plan permits credit bidding.

The interesting question arises when a plan proponent, typically the debtor, attempts to “cram down” an auction plan that forbids secured creditors from credit bidding. The cram-down provision—11 U.S.C. § 1129(b)—permits bankruptcy judges to confirm a plan of reorganization “if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.”⁴⁸ As nebulous as the concepts of fairness and equity are, application of the § 1129(b) standard generally lies within the sound discretion of the bankruptcy judge.⁴⁹ The Code does, however, provide some guidance. Under § 1129(b)(2)(A), a plan is “fair and equitable” only if, among other unspecified requirements, it protects secured claimants by (i) leaving liens intact, (ii) permitting them to credit bid as under a § 363 sale, or (iii) giving them the “indubitable equivalent” of their secured claims.⁵⁰

In other words, for a plan to clothe the bankruptcy judge with discretion to cram down, it must provide secured creditors with one of the three guarantees enumerated in subsections 1129(b)(2)(A)(i)-(iii). Alternative (i) is unlikely to appeal to a debtor trying to sell all of its assets because buyers do not want to risk having to redeem preexisting liens if the debtor fails to pay off the secured creditors in full. As a consequence, an auction plan needs to either set forth procedures consistent with § 363—in other words, permit credit bidding—or provide secured creditors with “the indubitable equivalent”⁵¹ of their secured claims.

⁴⁷ See 11 U.S.C. § 1129(a)(8).

⁴⁸ *Id.* § 1129(b)(1); see also Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133, 140-41 (1979).

⁴⁹ See *In re James Wilson Assocs.*, 965 F.2d 160, 172 (7th Cir. 1992).

⁵⁰ A plan is not confirmable through cram down unless it meets the following requirements:

(A) With respect to a class of secured claims, the plan provides—

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

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder’s interest in the estate’s interest in such property;

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

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

11 U.S.C. § 1129(b)(2)(A).

⁵¹ Congress borrowed this surprising statutory phrase from an opinion by Judge Learned Hand construing the old Bankruptcy Act. See *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935).

Chapter 11’s auction provisions essentially boil down to this: a debtor can auction its assets free and clear of secured creditors’ security interests through a 363 sale, effected either within bankruptcy or through a plan of reorganization, or it can propose a plan with sale procedures that provide the secured creditors “the indubitable equivalent” of their claims—if, to repeat, the plan is otherwise satisfactory.

III. TWO RECENT DECISIONS APPLYING § 1129(b)(2)

At this point, it should be obvious that secured creditors (who want the right to credit bid) and debtors (who may want to prohibit credit bidding) are interested in the question under what conditions, if ever, an asset-sale plan prohibiting credit bidding nevertheless supplies secured creditors with the indubitable equivalent of their secured claims. The Third and Fifth Circuits considered this question of statutory interpretation in two recent cases.⁵² Both courts held that § 1129(b) does not prevent a bankruptcy judge from confirming a sale plan that bars credit bidding—that, in other words, credit bidding is not a legal prerequisite to a cram down.⁵³ Instead, the courts reasoned, it is within the sound discretion of the bankruptcy judge to determine that a plan provides the indubitable equivalent of the secured claims.⁵⁴

The decisions thus tackled the validity of a categorical, legal question—whether a plan proposing to sell a debtor’s assets must allow secured creditors to bid credit in order to survive a cram down—but because of the answer that the courts reached, they also evaluated (even if only implicitly) the respective bankruptcy judges’ applications of discretion.

A. *In re Pacific Lumber Co.*

In re Pacific Lumber Co. presented a dispute over the assets of six affiliated debtors who together comprised a Humboldt County-based timber enterprise.⁵⁵ In bankruptcy, the stakeholders ultimately came to loggerheads over the treatment of two of the debtors: Pacific Lumber Company (“Palco”) and its wholly owned special purpose entity, Scotia Pacific LLC (“Scopac”).⁵⁶ Palco owed approximately \$160 million to its financier, Marathon Structured Finance (“Marathon”).⁵⁷ Palco’s assets included a

⁵² *In re Phila. Newspapers, LLC*, 599 F.3d 298, 301 (3d Cir. 2010); *Bank of N.Y. Trust Co., NA v. Official Unsecured Creditors’ Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229, 242-43 (5th Cir. 2009).

⁵³ *Phila. Newspapers*, 599 F.3d at 318; *Pac. Lumber*, 584 F.3d at 247.

⁵⁴ *Phila. Newspapers*, 599 F.3d at 304; *Pac. Lumber*, 584 F.3d at 247, 249.

⁵⁵ *Pac. Lumber*, 584 F.3d at 236.

⁵⁶ *Id.* at 236.

⁵⁷ *Id.*

sawmill, a power plant, a company town, and—of primary significance to the dispute—the equity or residual interest in Scopac and the other debtors.⁵⁸ Scopac, in turn, owned some 200,000 acres of prime redwood timberland in northern California,⁵⁹ as well as miscellaneous assets valued at around \$40 million.⁶⁰ Scopac was heavily indebted, however, to the tune of about \$780 million at the time of the bankruptcy petition.⁶¹ Scopac owed \$740 million to the so-called “Noteholders,” each of which held a secured interest in all of Scopac’s assets, and about \$40 million to Bank of America, which enjoyed a priming lien that allowed it to recover in full before the Noteholders could take anything.⁶²

In the course of the Chapter 11 proceedings, the bankruptcy court conducted a hearing to estimate the timberlands’ value, settling finally on a figure of \$510 million.⁶³ Although it was a creditor of Palco only, not Scopac, Marathon proposed a plan of reorganization under which it (together with a competitor logging company called Mendocino Redwood Company) would emerge from bankruptcy owning the reorganized debtors.⁶⁴ In this proposed plan, Marathon would contribute \$580 million in cash to satisfy the other creditors.⁶⁵ Coupled with its claim against Palco, this would leave Marathon with all of the debtors’ assets.⁶⁶ The plan proposed to pay Bank of America its \$40 million, leaving the Noteholders with a payout roughly equal to the value of Scopac’s miscellaneous, non-timberland assets plus about \$510 million, the bankruptcy court’s estimated value of the timberlands.⁶⁷

The Noteholders objected to Marathon’s plan, arguing that they ought to be allowed to bid their \$740 million credit for Scopac’s assets.⁶⁸ In essence, the Noteholders contended that the court’s estimate undervalued the timberlands and that with the ability to bid credit they could prove it.⁶⁹ The bankruptcy judge disagreed, concluding that because he had already valued the timberlands at \$510 million, a cash payment of that amount was the indubitable equivalent of a secured claim on the asset.⁷⁰ The judge allowed

⁵⁸ *Id.* at 236 & n.2. The other debtors in this matter included Britt Lumber Company, Inc., Scotia Inn, Inc., Salmon Creek, LLC, and Scotia Development Corp., LLC. *Id.* at 236 n.2.

⁵⁹ *Id.* at 236.

⁶⁰ *Id.* at 249 n.24, 250.

⁶¹ *Pac. Lumber*, 584 F.3d at 237.

⁶² *Id.* at 237, 239.

⁶³ *Id.* at 238.

⁶⁴ *Id.* at 236-37.

⁶⁵ *Id.* at 237.

⁶⁶ *Id.*

⁶⁷ *Pac. Lumber*, 584 F.3d at 238-39.

⁶⁸ *Id.* at 237, 239.

⁶⁹ *Id.* at 247.

⁷⁰ *Id.* at 238.

Marathon to cram down its plan under § 1129(b), and the sale was perfected.⁷¹

Appealing directly to the Fifth Circuit,⁷² the Noteholders argued that under the Code, a bankruptcy judge is not allowed to sign off on what amounts to a going-concern sale in which the secured creditors cannot bid with credit.⁷³ As the Noteholders saw it, to hold otherwise would render superfluous the second alternative of § 1129(b)(2)(A)—the alternative that a plan permit credit bidding as under § 363(k)—because it would always be easier to satisfy the indubitable-equivalent alternative.⁷⁴ They contended that because the second alternative alone refers to asset sales explicitly, it must be satisfied to cram down any plan contemplating a sale of assets (rather than a *bona fide* reorganization).⁷⁵

The Fifth Circuit affirmed, concluding that § 1129(b)(2) does not prevent plan confirmation just because assets are sold free and clear of liens without the secured creditors having the right to credit bid.⁷⁶ The court recognized that the “fair and equitable” standard must be satisfied before a court may cram down a reorganization plan.⁷⁷ It disagreed, however, with the Noteholders’ contention that a literal interpretation of the section would render the credit-bid alternative superfluous.⁷⁸ Remarking that the disjunctive “or” separated the three minima of § 1129(b)(2)(A), the court rejected the Noteholders’ invitation to transform the word “or” “into an ‘and.’”⁷⁹ It was senseless, the court concluded, to argue that a cash payment equivalent to the value of a secured claim treats the secured claimant unfairly.⁸⁰ Because the bankruptcy judge had valued the Noteholders’ collateral—the timberlands—at \$510 million, a cash payment in that amount was sufficient to confirm the plan, despite the presence of a credit bidder willing to contribute a higher bid.⁸¹

⁷¹ *Id.* at 238-39.

⁷² *Id.* at 239.

⁷³ *Pac. Lumber*, 584 F.3d at 245.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.* at 245-46.

⁷⁷ *Id.* at 244.

⁷⁸ *Id.* at 246.

⁷⁹ *Pac. Lumber*, 584 F.3d at 245-46 (quoting *Heartland Fed. Savings & Loan Ass’n v. Briscoe Enters., Ltd.*, II (*In re Briscoe Enters., Ltd.*, II), 994 F.2d 1160, 1168 (5th Cir. 1993)) (internal quotation marks omitted).

⁸⁰ *Id.* at 246.

⁸¹ *Id.* at 248-49.

B. *In re Philadelphia Newspapers, LLC*

The same legal question presented itself in *In re Philadelphia Newspapers, LLC*.⁸² The debtors⁸³ in *Philadelphia Newspapers* were affiliated entities that together owned and operated several local news publications.⁸⁴ Collectively they owed about \$300 million to their secured creditors (“the lenders”), whose security interests covered substantially all of the debtors’ assets.⁸⁵ With the benefit of Chapter 11 protection, the debtors proposed a plan under which they would surrender their building (valued at roughly \$30 million) and turn over the cash proceeds of a planned auction of the rest of their assets (which would fetch an additional \$36 million), for a total recovery to the lenders, after payment of administrative claims and expenses, of \$66 million.⁸⁶ The debtors were able to project auction proceeds with some certainty because they had already received a bid in a similar amount from a Delaware stalking horse called, confusingly, Philly Papers, LLC.⁸⁷

As it turns out, Philly Papers was not exactly an arm’s-length bidder. One of its principals, Bruce Toll, was also the chairman of Philadelphia Media Holding, a limited liability company that doubled as, suspiciously, the debtors’ corporate parent.⁸⁸ Another of the stakeholders in Philly Papers, the Carpenters Pension Fund, also held equity in the holding company.⁸⁹ The stalking horse was thus largely composed of people with ties to the debtors’ managers—insiders, so to speak.

The lenders, needless to say, were unimpressed with the idea of Bruce Toll exiting bankruptcy owning the very newspapers he started with, bought on the cheap. When the debtors moved in the bankruptcy court for authorization of their preferred auction procedures, the lenders objected.⁹⁰ Notably, the proposed procedures forbade credit bidding because, as the debtors put it, they wanted the winning bidder to be able to “write a check.”⁹¹ The practical effect of the proposed procedures would have been to assure that Philly Papers won the auction. The bankruptcy judge denied the

⁸² See *In re Phila. Newspapers, LLC*, 599 F.3d 298, 301 (3d Cir. 2010).

⁸³ The bankruptcies of a handful of affiliates were procedurally consolidated. See *Phila. Newspapers*, 599 F.3d at 301 & n.1.

⁸⁴ *Id.* at 301.

⁸⁵ *Id.*

⁸⁶ *Id.* at 301-02; *In re Phila. Newspapers, LLC*, No. 09-11204SR, 2009 WL 3242292, at *2 (Bankr. E.D. Pa. Oct. 8, 2009), *rev’d in part*, 418 B.R. 548 (E.D. Pa. 2009), *aff’d*, 599 F.3d 298 (3d Cir. 2010).

⁸⁷ *In re Phila. Newspapers, LLC*, 418 B.R. 548, 554 (E.D. Pa. 2009), *aff’d*, 599 F.3d 298 (3d Cir. 2010).

⁸⁸ *Phila. Newspapers*, 2009 WL 3242292, at *10.

⁸⁹ *Id.*

⁹⁰ *Phila. Newspapers*, 599 F.3d at 302.

⁹¹ *Phila. Newspapers*, 2009 WL 3242292, at *11 (internal quotation marks omitted).

debtors' motion, explaining that he would only authorize an auction that permitted the lenders to credit bid.⁹² He observed the apparent unseemliness of the Philly Papers bid, or, as we might rather put it, the unlikely proposition that it could be taken on faith, without meaningful testing, that people closely associated with the debtors' residual owner were the highest bidders.⁹³

Rather than deny the debtors' motion as a matter of discretion, however, the judge rejected their proposed plan as a matter of statutory interpretation.⁹⁴ He held that the text of § 1129(b)(2)(A) barred a liquidation plan whose auction procedures were inconsistent with § 363(k).⁹⁵ After all, the court reasoned, § 1129(b)(2)(A) enumerates three ways that a plan can satisfy the "fair and equitable" cram-down requirement.⁹⁶ If an auction in which credit bidding is forbidden could be fairly called the "indubitable equivalent" of secured claims, there would be no reason for the statute to list separately the alternative requirement that such a plan provide a sale complying with § 363(k).⁹⁷ Subsection (b)(2)(A)(iii) would totally swallow (b)(2)(A)(ii).⁹⁸

An interlocutory appeal followed, and the district court reversed the bankruptcy court's ruling and remanded the matter.⁹⁹ Citing *Pacific Lumber*, Judge Robreno concluded that a fair auction *can* produce a recovery that is the indubitable equivalent of a secured creditor's secured claim, even without credit bidding.¹⁰⁰

A divided panel of the Third Circuit affirmed.¹⁰¹ Like the Fifth, the Third Circuit focused on what it considered the plain meaning of § 1129(b)(2)(A). The court explained that "[t]he 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."¹⁰² Unlike Judge Ambro, whose dissent would have construed the section by reference to context and legislative history and would have held that subsection (ii) governs every plan proposing to sell assets free and clear of liens,¹⁰³ the majority perceived no ambiguity in the language.¹⁰⁴

⁹² *Id.*

⁹³ *Id.* at *5, *10-11.

⁹⁴ *Id.* at *5-9.

⁹⁵ *Id.* at *5-6, *9.

⁹⁶ *Id.* at *5.

⁹⁷ *Phila. Newspapers*, 2009 WL 3242292, at *6.

⁹⁸ *Id.* at *5.

⁹⁹ *In re Phila. Newspapers, LLC*, 418 B.R. 548, 552, 575 (E.D. Pa. 2009), *aff'd*, 599 F.3d 298 (3d Cir. 2010).

¹⁰⁰ *Id.* at 571-72.

¹⁰¹ *In re Phila. Newspapers, LLC*, 599 F.3d 298, 301 (3d Cir. 2010).

¹⁰² *Id.* at 305.

¹⁰³ *Id.* at 328 (Ambro, J., dissenting).

¹⁰⁴ *Id.* at 311 (majority opinion).

In combination, *Pacific Lumber* and *Philadelphia Newspapers* are important authority for the proposition that asset sales need not include the credit bids of secured creditors. The Fifth Circuit did observe, to be fair, that a confirmable plan must *include* one of the three alternatives under § 1129(b)(2)(A): “Even a plan compliant with these alternative minimum standards is not necessarily fair and equitable.”¹⁰⁵ But the analysis stopped there and did not consider whether credit bidding might constitute an unenumerated requirement to render confirmable a plan that proposes an asset sale. Consequently, neither *Pacific Lumber* nor *Philadelphia Newspapers* teaches anything about when credit bidding might be required, advisable, inadvisable, or prohibited or by what principles a bankruptcy court’s decision ought to be reviewed.

IV. THE CORRECT APPROACH TO RESOLVING CREDIT BID DISPUTES UNDER § 1129(b)

The natural question, and the one toward which this Essay is directed, is whether *Pacific Lumber* and *Philadelphia Newspapers* correctly applied the Bankruptcy Code and, if not, how they ought to have done so. In sum, our view is as follows. The Code does not by its terms require that secured creditors have the opportunity to bid credit for a judge to cram down an asset-sale plan. Consistent with the analysis of both the Third and Fifth Circuits, we agree that the disjunctive “or” separating the alternative minimum requirements of § 1129(b)(2)(A) precludes treating subsection 1129(b)(2)(A)(ii) (the credit-bidding provision) as an addition to subsection 1129(b)(2)(A)(iii) (the indubitable-equivalent criterion) rather than its alternative. We think, however, that the three alternative minimum requirements are a red herring that distracted the courts from answering the ultimate question: whether approving a plan without credit bidding is an abuse of discretion. As the Fifth Circuit recognized in *Pacific Lumber*, a plan’s satisfaction of § 1129(b)(2)(A) is necessary but not sufficient to justify a cram down¹⁰⁶—necessary, in other words, to vest the bankruptcy court with a discretion that is itself independently reviewable.

Discretion is not unbridled. It is, as has been said, “exercised under law,”¹⁰⁷ and a judge abuses his discretion in a bankruptcy case where he destroys creditor recovery without justification. We argue that although judges may cram down an auction plan excluding credit bids as a matter of law, courts abuse their discretion where they forbid creditors with a security

¹⁰⁵ Bank of N.Y. Trust Co., NA v. Official Unsecured Creditors’ Comm. (*In re Pac. Lumber Co.*), 584 F.3d 229, 245 (5th Cir. 2009).

¹⁰⁶ *Id.*

¹⁰⁷ Ball v. City of Chi., 2 F.3d 752, 755 (7th Cir. 1993) (quoting *In re Oil Spill by the Amoco Cadiz*, 954 F.2d 1279, 1334 (7th Cir. 1992) (per curiam)) (internal quotation marks omitted).

interest in all of the assets for sale to credit bid. Such a rule would not only harmonize with the Code's apparent preference for credit bidding,¹⁰⁸ it would tend to maximize the recovery to a debtor's creditors.

A. *The Code*

Section 1129(b)(1) permits a bankruptcy judge to confirm a plan, including a plan under which the debtor sells its assets, only if it "does not discriminate unfairly, and is fair and equitable," with respect to each objecting class of creditor.¹⁰⁹ To be "fair and equitable," the Code explains, the plan must include *at least* one of the protections for secured creditors enumerated in § 1129(b)(2).¹¹⁰ In practical terms, the plan must either permit credit bidding or supply secured creditors with the "indubitable equivalent" of their claims. A plan providing one of these protections, to put things the other way around, may be confirmed notwithstanding a class's objection if it otherwise "does not discriminate unfairly, and is fair and equitable."¹¹¹

The *Pacific Lumber* and *Philadelphia Newspapers* courts recognized, properly as we see it, that the "indubitable equivalent" of subsection 1129(b)(2)(A)(iii) is an alternative to the credit bidding contemplated by subsection 1129(b)(2)(A)(ii). To cloak the bankruptcy court with discretion to cram down, the plan need not supply both protections. Because the Code contemplates judicial valuation of secured claims,¹¹² a plan may well provide the indubitable equivalent of a claim—by, say, paying the judicially estimated value of the security in cash, as the *Pacific Lumber* plan proposed to do—without permitting credit bidding.

So far, so good. The crucial point to see, for our purposes, is that a plan's satisfaction of the indubitable-equivalent provision does not imply that the plan should be confirmed. It only gives the bankruptcy judge authority to confirm the plan if it is otherwise *fair*.¹¹³ This opaque criterion

¹⁰⁸ Credit bidding can be prohibited in an asset sale under § 363, but only "for cause." 11 U.S.C. § 363(k) (2006).

¹⁰⁹ *Id.* § 1129(b)(1).

¹¹⁰ For the list, see *id.* § 1129(b)(2)(A). We note that courts often speak of the "fair and equitable" phrase as codifying the rule of absolute priority among creditor classes. *E.g.*, *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452, 462-63 (2d Cir. 2007); *Official Comm. of Unsecured Creditors v. Dow Corning Corp. (In re Dow Corning Corp.)*, 456 F.3d 668, 672 (6th Cir. 2006); *In re Armstrong World Indus., Inc.*, 432 F.3d 507, 512-13 (3d Cir. 2005). No one believes, however, that the words "fair" and "equitable" are lexically synonymous with the principle that a senior class of creditors must recover in full before its junior classes can take anything. Rather, what courts mean when they say the absolute-priority rule is "codified" is that to violate it is never fair and equitable—that therefore a bankruptcy judge never has discretion to cram down a plan rejecting absolute priority. The formal similarity to our argument should be clear.

¹¹¹ 11 U.S.C. § 1129(b)(1).

¹¹² *See id.* § 506(a)(1).

¹¹³ *See id.* § 1129(b)(1).

of judgment must receive its meaning, if it is to have any at all, from the purposes of plans of reorganization and of bankruptcy generally. More on this below; for now, it suffices to observe that a world of fairness is a world of discretion.¹¹⁴

Apart from giving § 1129 what we think is its best reading, the rule that a bankruptcy judge has discretion to cram down an asset-sale plan without credit bidding has the happy consequence of harmonizing with § 363(k). That provision, recall, instructs that when a debtor-in-possession sells property other than in the ordinary course of business, secured creditors must be allowed to bid for the assets with credit “unless the court for cause orders otherwise.”¹¹⁵ A bankruptcy judge enjoys discretion, in other words, if he has reason to permit asset sales in which credit bidding is prohibited.¹¹⁶

Sections 363 and 1129 offer a debtor two procedural mechanisms by which to sell itself as a going concern—one within bankruptcy, the other pursuant to a plan to emerge reorganized from Chapter 11. There is no reason to prefer one mechanism over the other; that is, as a general matter, there is no reason to channel debtors toward one or the other section of the Code. In any given case, one avenue may, of course, outshine the other—hence the choice!—but neither is superior in the abstract. A Code under which the choice of section number determines the auction rules is, however, a Code that implicitly directs debtors one way or the other without a good bankruptcy justification. A debtor that wishes to shape auction rules will have a preference for the option that gives it maximum control. If § 363 is the likeliest choice to oust credit bidders, a debtor wanting cash-only bids is much more likely to sell assets within Chapter 11, and vice versa if § 1129 were interpreted to give the debtor more power. But neither the Code’s text nor a sensible economic theory suggests that a debtor should be able to manipulate the framework of an asset sale by electing one or another section number. Put differently, there is no social benefit to allowing a debtor to gain an advantage by opting for one or the other route to the same destination.

Our proposed reading of § 1129 overcomes the problem entirely. Under our reading, the bankruptcy judge decides one question whenever a debtor-in-possession sells its assets—whether there is good cause, in the

¹¹⁴ Although the Code specifies requirements that, if not met, preclude confirmation of a plan of reorganization, the ultimate decision to confirm is entrusted to the bankruptcy court’s discretion. *E.g.*, *United States v. AWECO, Inc. (In re AWECO, Inc.)*, 725 F.2d 293, 297-98 (5th Cir. 1984); *see, e.g.*, *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*, 787 F.2d 1352, 1364 (9th Cir. 1986). As in other areas of law, discretion means “a discretion exercised not arbitrarily or willfully, but with regard to what is right and equitable under the circumstances and the law.” *AWECO*, 725 F.2d at 298 (quoting *Langnes v. Green*, 282 U.S. 531, 541 (1931)) (internal quotation marks omitted).

¹¹⁵ 11 U.S.C. § 363(k).

¹¹⁶ For the proposition that such a decision is discretionary, which we think is easily defended, *see* *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 459 (3d Cir. 2006).

case at hand, to prohibit credit bidding—and reviewing courts are uniformly charged to answer whether the judge’s conclusion was an abuse of discretion.

B. *Auctions, Transaction Costs, and the Scope of the Bankruptcy Court’s Discretion*

Because the text and structure of § 1129 neither compel nor proscribe credit bidding, the Code leaves the decision to authorize the procedure to the sound discretion of the bankruptcy court. The question remains how the court should or, one might say, must exercise that authority. To recapitulate our opening premise, bankruptcy judges overseeing an asset sale must always exercise their discretion with an eye towards maximizing the selling price for the debtor’s assets. As we show below, credit bidding is likely to produce an auction with more bidders and lower transaction costs, which means higher expected returns to creditors. We thus conclude that it should always be held an abuse of discretion for a judge to confirm a plan prohibiting credit bids, at least where a creditor’s security interest reaches all the assets up for auction.

1. Auctions 101

Auction optimization theory is a well-developed field that studies complicated concepts largely outside the scope of this Essay. Nonetheless, we adumbrate here the basic and largely intuitive concepts at work in most every auction. When a seller auctions his asset, he has in mind a selling price—economists dub it the reservation price—below which he is unwilling to part with his property.¹¹⁷ The seller’s incentive, assuming he is profit-maximizing, is thus to sell his asset for as high a price as possible above his reservation price.¹¹⁸ A buyer has a reservation price as well, which is the highest amount she is willing to pay to purchase the seller’s asset.¹¹⁹ The profit-maximizing buyer’s incentive is, unsurprisingly, the mirror image of the seller’s: acquire the asset for as much as possible below her reservation price.¹²⁰ In a typical open ascending price auction—also referred to as an English auction—the bidding begins at the seller’s reservation price be-

¹¹⁷ Ian Steedman, *Reservation Price and Reservation Demand*, in 4 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 158, 158 (John Eatwell, Murray Milgate & Peter Newman eds., 1998).

¹¹⁸ See John G. Riley & William F. Samuelson, *Optimal Auctions*, 71 AM. ECON. REV. 381, 382 (1981); Randall S. Thomas & Robert G. Hansen, *Auctioning Class Action and Derivative Lawsuits: A Critical Analysis*, 87 NW. U. L. REV. 423, 438 (1993).

¹¹⁹ See Riley & Samuelson, *supra* note 118.

¹²⁰ See Steedman, *supra* note 117, at 158-59.

cause he is unwilling to sell the item for less.¹²¹ Would-be buyers then openly bid against each other, with each successive bid exceeding the previous one by some preset, minimum overbid amount. The bidding continues until no participant is willing to bid further, at which point the highest bidder “wins” the auction and purchases the asset for the amount of her final bid.¹²²

Under this typical auction format, it is readily apparent that a seller benefits from increased competition between bidders. To illustrate the point, suppose a seller is auctioning a widget. His reservation price is \$100, and the auction rules dictate that each bid must top the previous one by at least a dollar. Two bidders, B_1 and B_2 , participate in the auction. B_1 's reservation price is \$150, while B_2 's is \$250. B_1 starts the bidding at \$100, the minimum opening bid per the seller's reservation price, and B_2 follows with a topping bid of \$101. B_1 then submits a bid of \$102 that B_2 again exceeds by a dollar, and so on. The bidding war between B_1 and B_2 continues until B_1 bids \$150 and B_2 tops with a bid of \$151. Because B_1 is not willing to buy the widget for more than her \$150 reservation price, she will not top B_2 's bid. Consequently, \$151 will prove the final bid, and B_2 will purchase the widget at that price.

The \$99 spread between B_2 's \$151 winning bid and her \$250 reservation price represents money the seller could have captured had the auction produced increased competition between B_2 and other would-be buyers. Put differently, B_2 was willing to pay \$99 more than she did for the widget. She did not do so only because the competing bidder, B_1 , did not force her to bid more than the \$151 purchase price. If only a third bidder, B_3 , with a reservation price of \$249 had participated in the auction, the seller would have collected \$250 for the widget, the maximum amount possible given the bidders' respective reservation prices. With B_3 in the mix, all three bidders would have bid against each other until the price reached \$150. At that price level, B_1 would stop bidding, as before. The auction would then become a two-way contest between B_3 and B_2 , with each topping the other's offer until B_3 bid \$249, her reservation price. Because B_2 is willing to pay exactly \$250 for the widget, she would top B_3 's bid by a dollar, “winning” the widget for \$99 more than she would have otherwise paid had B_3 not shown up at the auction house.

One can express the takeaways from this simple hypothetical generically. Where an auction requires a relatively small minimum overbid in-

¹²¹ Vernon L. Smith, *Auctions*, in 1 THE NEW PALGRAVE, *supra* note 117. We demonstrate the intuition behind English auctions because they are the most typical and accessible to lay readers. The basic intuitions gleaned from the English-auction illustrations are applicable to other auction formats as well, including competitive sealed tenders (so-called silent auctions) and declining-price auctions (also referred to as Dutch or clock auctions). *See generally id.* at 138-39 (explaining sealed and declining-price auctions).

¹²² *Id.* at 138.

crement (m), the theoretical winning bid (w) should equal the second-highest reservation price (r_2) plus the overbid increment such that $w = r_2 + m$. The intuition behind that generic prediction is not far to seek. Economic self-interest encourages the bidder with the highest reservation price, like all bidders, to obtain the asset for as low a price as possible. Competition between bidders will eventually push the bid to the reservation price of the would-be buyer with the second-highest reservation price. The highest-value user of the asset will then top that bid by the minimum overbid amount. With no other bidders willing to pay m more for the asset, a price of $r_2 + m$ will win the auction.¹²³ The perhaps surprising upshot is that there are only two bidders who ultimately set an asset's final sale price: the auction's winner (the bidder with the highest reservation price) and its runner up (the bidder with the second-highest reservation price).

2. The Value of Additional Bidders

If only two bidders are responsible for the price at which an asset will sell, one may wonder why opening the auction to all and sundry is the seller's optimal strategy. To maximize his auction proceeds, one might think, a seller should simply unlock the doors of the auction house to the two bidders with the highest and the second-highest reservation prices for the assets on the block. Yet how is a seller to identify these bidders in advance of the auction? A buyer has obvious incentives not to advertise the top price he is willing to pay for the seller's wares.¹²⁴ Seeking to maximize his sale proceeds but unable to finger the winning bidder and the runner up pre-sale, it follows that a seller's efficient solution is to permit *every* bidder with sufficient financial means to participate in the auction.¹²⁵ Bidders with reservation prices below the second-highest reservation price, such as B_1 in our hypothetical above, will neither win the auction nor increase the final price. But nor will they depress the winning price, and thus they do the seller no harm. Excluding an interested buyer, on the other hand, where every bidder potentially represents the auction participant with the highest or second-highest reservation price, creates a risk the seller has no reason to take.

It follows that keeping a credit bidder from participating in a bankruptcy auction is an unsupportable strategy, at least for a debtor intent on

¹²³ There are situations where this formula does not hold. For instance, if the difference between the highest reservation price (r_1) and the second-highest reservation price (r_2) is less than m , it is possible for the bidder with the second-highest reservation price to win the auction with a bid between $r_1 - m$ and r_2 . This circumstance and others like it can be safely ignored, as they do not in any way diminish the positive influence of additional bidders in general or credit bidding in particular on the winning bid.

¹²⁴ See *Ball Mem'l Hosp., Inc. v. Mut. Hosp. Ins., Inc.*, 784 F.2d 1325, 1344 (7th Cir. 1986).

¹²⁵ See David Hahn, *When Bankruptcy Meets Antitrust: The Case for Non-Cash Auctions in Concentrated Banking Markets*, 11 STAN. J.L. BUS. & FIN. 28, 67 (2005).

maximizing its sale proceeds. All else being equal, there is a non-trivial probability that the credit bidder will be the highest or second-highest value user of the assets that the debtor proposes to sell. Forbidding the credit bidder from credit bidding thus reduces the expected returns from the sale.

But all else may not be equal. As a secured party, the creditor wishing to credit bid is likely more familiar with the debtor's business and assets than are other prospective buyers.¹²⁶ Through its history of monitoring the debtor, the credit bidder may be privy to information about the true value of the collateral the debtor is selling that is not apparent to other would-be bidders. If we assume that information asymmetries will generally reduce the value an outsider is willing to pay for a debtor's assets, the credit bidder may be the *most* likely party to have the highest reservation price. The secured creditor is the very bidder the debtor cannot afford to deter from bidding—at least if it does not wish to leave money on the table.

But what if it does? As the facts of *Philadelphia Newspapers* demonstrate, there is often doubt, to put it charitably, that the debtor's managers are truly interested in maximizing the proceeds from a bankruptcy sale. Because corporations and the people who manage them often have misaligned interests, it is hardly implausible that a debtor's officers would seek to sell the bankrupt's business to a low-value bidder in exchange for some personal remuneration that does not redound to the benefit of the enterprise as a whole. Senior creditors, who bear the costs of this form of managerial perfidy, are already incentivized to prevent inefficient sales. Credit bidding affords them a ready tool to effectively act on that incentive. Put simply, increasing the stock of interested bidders is a bankruptcy court's best check against a management effort to rig the results of an auction. On the flip side, keeping willing buyers from casting bids is the most effective means for management to steer the debtor's assets to a favored, low-value purchaser.

As between authorizing and forbidding credit bidding, then, a bankruptcy court's decision should be all but automatic. Credit bidding increases the number of knowledgeable bidders at the auction while serving as a check against management malfeasance. Those benefits in themselves suggest that credit bidding is an unalloyed good. Yet credit bidding produces at least one more benefit for a debtor's creditors that a court should consider when deciding, in its discretion, whether to allow the procedure: reducing transaction costs.

¹²⁶ Because the value of a security interest depends on the value of the collateral, secured creditors are often willing to bear the costs of monitoring the debtor's business in order to protect the value of their collateral.

3. Reducing Transaction Costs

As we have explained, a buyer comes to an auction with a discrete reservation price representing the maximum amount she is willing to pay for the seller's assets. From the buyer's perspective, it is irrelevant what percentage of the ultimate purchase price ends up in the seller's pocket. To illustrate, suppose Sotheby's is auctioning a Rembrandt and an art collector is prepared to pay a total of \$110 million to purchase the painting. If Sotheby's requires winning bidders to pay a \$10 million fee, the collector will bid no more than \$100 million for the artwork.¹²⁷ For she is willing to pay a total of only \$110 million for the painting, regardless of how the auctioneer and the owner divide the proceeds. If the Rembrandt's owner could persuade Sotheby's to lower its fee, every dollar in reduced commission would translate into an additional dollar that the collector (and every other bidder) would be willing to bid on the painting. The higher the bids, the greater the owner's enrichment.¹²⁸

Credit bidding has the same effect as reducing the auctioneer's commission because allowing the secured creditor to bid with credit eliminates its costs of obtaining capital. Recall our highly stylized example from Part I where the debtor owes a secured creditor \$1,000 and the creditor wishes to purchase the debtor's only asset. To show that credit bidding replicates the results of an all cash deal, we sent the secured creditor to obtain a \$1,000 loan from the Bank. The money was then shuffled from the Bank to the creditor to the debtor back to the creditor all the way back to the Bank, leaving the secured creditor with the asset and no net cash outlay. Absent transaction costs, then, we concluded that credit and cash bidding are economic equivalents.

But an economist who assumes away transaction costs is like a physicist who assumes away friction. In the real world, transaction costs are an actual cost of doing business. The Bank, after all, is not a charitable enterprise. If the creditor seeks a loan, even one with a short duration that is highly secured, he will have to pay the Bank for the use of its money. The Bank's interest and fees for the deal, like Sotheby's commission, will reduce the amount the credit bidder is willing to bid for debtor's assets on a one-for-one basis. For the purposes of an exemplar hypothetical, we can perhaps assume away the interest and fees on a \$1,000 loan. But where the

¹²⁷ We recognize that sellers sometimes pay an auctioneer's commission, but the party who foots the bill has no bearing on the point we are making. If Sotheby's takes a piece of the action, the seller will end up with less, irrespective of whether the collector or the seller writes the commission check. For ease of illustration, then, we assume that the buyer must bear the transaction costs of the auction.

¹²⁸ Note that the \$10 million commission reduces by that amount the top bid of every bidder, including the one with the second-highest reservation price. Though the equation $w = r_2 + m$ still holds, it is only by defining w as the total expenditure to purchase the painting. The proceeds to the seller (p) is expressed by $p = r_2 - \$10 \text{ million} + m$.

alternative to credit bidding is to require that secured creditors who wish to bid raise \$740 million dollars in cash, as in *Pacific Lumber*, or up to \$300 million, as in *Philadelphia Newspapers*,¹²⁹ we can no longer dismiss the costs of securing capital. Putting together deals of those sizes, however temporary and secure the loans, would needlessly generate millions of dollars in fees and interest,¹³⁰ all for the creditors to remit cash that the court will return to them. Reducing, in turn, by several million dollars the size of the creditors' recovery is no way for a bankruptcy judge to run an auction.

C. *Objections to Allowing Credit Bidding in Bankruptcy Auctions*

A critic of credit bidding might offer several objections to our policy analysis. The most common (and weakest) among them is that increasing the number of bidders is a seller's optimal strategy only where all of the bidders are prepared to pay with cash. Increasing the pool of potential buyers with non-cash bidders, the argument goes, is like inviting bidders to purchase the debtor's assets with apples and oranges.¹³¹ We can easily dispose of this criticism. We have already shown that credit bidding precisely matches the results of an all-cash bid. Said differently, the value of the secured creditor's credit has a discrete and easily identified cash value. Forbidding credit bidding on the ground that credit is not cash is tantamount to prohibiting cash bidders from bidding with two fifty-dollar bills in lieu of a single, hundred-dollar note.

A more serious variant of this objection is that credit bidding deters cash bidders. On this view, would-be bidders who would otherwise participate in the auction take note of the size of the debtor's liability to the secured creditors. To the extent the credit—the credit bidder's currency at auction—eclipses a would-be bidder's actual or perceived value of the assets, that party knows that the secured creditor can easily outbid his reserva-

¹²⁹ See *In re Phila. Newspapers, LLC*, 599 F.3d 298, 301 (3d Cir. 2010); *Bank of N.Y. Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229, 237 (5th Cir. 2009).

¹³⁰ For instance, when we wrote this Essay in January of 2010, the three-month LIBOR rate was at a historically low 0.25 percent. See *LIBOR Rates History*, WALL ST. J. PRIME RATE, http://www.wsjprimerate.us/libor/libor_rates_history.htm (last visited Sep. 5, 2010). Even at that depressed rate of interest, the secured creditors in *Pacific Lumber* would have incurred \$1,850,000 in interest expenses to borrow the \$740 million face amount of their loan. And that figure does not include any lender fees and other costs (such as legal expenses) that assuredly would accompany a loan of that size.

¹³¹ See *In re Homestead Partners, Ltd.*, 197 B.R. 706, 719 n.15 (Bankr. N.D. Ga. 1996) (explaining that allowing credit bidding in an auction would be like allowing the main competitor to bid with a "currency of no consequence"); Lawrence Ponoroff, *The Dubious Role of Precedent in the Quest for First Principles in the Reform of the Bankruptcy Code: Some Lessons from the Civil Law and Realist Traditions*, 74 AM. BANKR. L.J. 173, 196 n.117 (2000) (stating that credit bidding undermines competition because secured creditors have an "enormous advantage over cash bidders").

tion price. He may thus elect to forgo the auction altogether rather than compete with the party destined to purchase the assets. If other cash bidders make the same election, credit bidding actually reduces the number of auction participants, depressing the ultimate winning bid.¹³²

This objection is unpersuasive, as there is nothing about the argument specific to credit bidding. Instead, the argument rests on the notion that bidders with deep pockets may deter bidders with limited resources. For instance, if a would-be bidder knows that Warren Buffett plans to attend an auction, she is also surely aware that Buffett can top her reservation price for any or all of the assets on the block. Yet nobody proposes to ban wealthy *cash* bidders from participating in a bankruptcy auction.

That, of course, makes good economic sense. Would-be bidders understand that a deep-pocketed player's *ability* to top their reservation price does not imply a *willingness* to do so. Warren Buffett did not become wealthy by overpaying for things, so it is possible, indeed, probable, that his reservation price for an asset at auction will be beneath that of another buyer. And buyers know this in advance. The same logic holds for secured creditors. By bidding a particular sum on credit, the secured creditors are eschewing the cash they would otherwise receive for any cash offer beneath their bid. Buyers therefore know that a credit bidder will not bid all of his credit unless he *actually* values the assets for that price. That the secured creditor may have a lower reservation price should prove sufficient to attract interested cash bidders to the auction.

A final objection is that credit bidding is unnecessary because the secured creditor can always obtain a short-term loan to bid for the debtor's assets. Banning the procedure, therefore, does not reduce the number of bidders at auction. Let us put to one side that this rejoinder fails to account for transaction costs, which we have already demonstrated reduce creditor recoveries. Because credit bidding exactly mirrors the results of an all-cash bid, it does stand to reason—assuming efficient capital markets—that secured creditors should be able to procure the financing to participate in an auction. At first cut, then, a judge's refusal to permit the procedure may not seem problematic.

A deeper look confirms, however, that prohibiting credit bidding is often the same as preventing the secured creditors from submitting a bid. Most lenders would likely be willing to lend secured creditors the capital they need to submit a bid given the short duration of the loan (the time it takes to pass from the creditor to the debtor back to the creditor) and the near certain prospect of getting repaid. But lenders do not hand out \$740 million or \$300 million casually. They require time to conduct due dili-

¹³² See, e.g., *In re Phila. Newspapers, LLC*, No. 09-11204SR, 2009 WL 3242292, at *4 (Bankr. E.D. Pa. Oct. 8, 2009) (noting that debtors argued that credit bidding should be precluded because it would chill competitive bidding by disincentivizing other bidders from becoming involved in the sale process), *rev'd in part*, 418 B.R. 548 (E.D. Pa. 2009), *aff'd*, 599 F.3d 298 (3d Cir. 2010).

gence to ensure that, for instance, the secured creditor actually has a perfected security interest in all of the collateral up for sale. Where the time between the announcement and performance of the auction can be as truncated as a matter of days,¹³³ secured creditors may lack the time to secure capital. And while capital markets are generally efficient, the recent financial crisis confirms that there are periods where capital is scarce even to the most credit-worthy borrowers. Because those times will positively correlate with a high number of bankruptcy filings and requests to credit bid,¹³⁴ forcing secured creditors to raise cash from the market may effectively stop them at the auction-house door.

If credit bidding is the equivalent of a cash offer, and forcing creditors to borrow cash may prove successful but may not, there seems no reason to prohibit the procedure on the ground that the interested credit bidder ought to just obtain a day loan.

CONCLUSION

Now that most Chapter 11 “reorganizations” are glorified asset sales in which the debtor uses bankruptcy to prepare itself for auction, the design of sale procedures has become a paramount concern to bankruptcy practitioners and courts. This Essay has endeavored to show that credit bidding tends to augment—and cannot depress—total creditor recoveries and that it therefore should be a mandatory feature of bankruptcy auctions. This conceit is not just in keeping with sound bankruptcy policy. It is consistent with the text of the Bankruptcy Code, which entrusts the decision to cram down a plan to the sound discretion of the bankruptcy court. A court cannot properly exercise its discretion to design a sale without taking into account the effect its decision will have on creditor recoveries. And because it is always an abuse of discretion to forbid an auction device that can increase but not lower stakeholder recoveries, we conclude that bankruptcy courts should be obligated to permit credit bidding.

¹³³ See *supra* note 8.

¹³⁴ See generally *Bankruptcy Statistics*, U.S. COURTS, <http://www.uscourts.gov/Statistics/BankruptcyStatistics.aspx> (last visited Sep. 5, 2010) (providing comparison tables documenting the overall increased number of bankruptcy filings in recent years).