No. 11-166

In The
# Supreme Court of the United States

RADLAX GATEWAY HOTEL, LLC, ET AL.,

*Petitioners,*

v.

AMALGAMATED BANK,

*Respondent.*

**On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit**

## BRIEF FOR BANKRUPTCY SCHOLARS AS *AMICI CURIAE* IN SUPPORT OF THE PETITIONERS

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## INTEREST OF *AMICI*

*Amici curiae* are law scholars who write and teach about bankruptcy and corporate reorganization.[1]

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[1] The parties have consented to the filing of this brief, written evidence of which accompanies the filing. The parties received notice at least 10 days prior to the due date of *amici curiae*'s intention to file this brief. No counsel for a party authored this brief in whole or in part, and no person (other than *amici curiae* or their counsel) made a monetary contribution intended to fund the preparation or submission of this brief.

*Amici* have a professional interest in illuminating this Court's consideration of the important and complicated questions this case presents.

## SUMMARY OF ARGUMENT

This case presents the question of whether a bankruptcy court may confirm a plan of reorganization that proposes to sell substantially all of the debtor's assets without permitting secured creditors to bid with credit. The courts of appeals are divided two to one over the question, with the Third and Fifth Circuits holding that creditors are not entitled to credit bid and the Seventh Circuit below holding to the contrary. *Amici* urge the Court to grant the petition notwithstanding the somewhat shallow circuit split because: (1) the appellate courts have extensively considered the question presented; (2) the doctrine of "equitable mootness" impedes the development of deeper splits over legal questions concerning plans of reorganization; (3) an unusually permissive venue statute allows debtors to forum shop, increasing the importance of providing a uniform national construction of the Bankruptcy Code; and (4) the answer to the question presented holds billions of dollars in the balance.

## ARGUMENT

### I. Credit Bidding in the Scheme of Modern Corporate Reorganization

The classical purpose of Chapter 11 is to "empower a debtor with going concern value to reorganize its operations to become solvent once more." *N.C.P. Mktg. Grp., Inc. v. BG Star Productions, Inc.*, 129 S. Ct. 1577, 1577 (2009) (Kennedy, J., statement respecting denial of certiorari). The paradigm of reorganization was the debt-laden railroad of the 19th century. The railroad may have been profitable as a going concern, but cash flows were insufficient to service the sizable debt taken on to finance construction. The railroad's long stretches of track would have been worthless if repossessed and broken apart, and yet no buyer could raise enough capital to purchase the entire enterprise. A restructuring was the only suitable means of maximizing creditor recoveries. It could enable a valuable firm to rework its balance sheet in an orderly fashion, shedding liabilities that could not be timely repaid while providing creditors ownership in a restructured, viable business. *See, e.g.*, DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (2003).

Modern day financing has worked a sea change in the bankruptcy landscape. Now that multi-billion dollar financings are commonplace, even large debtors can often sell themselves wholesale to an interested buyer. The primary function of Chapter 11 has changed accordingly. Once a legal device to bring about reorganization, Chapter 11 is now predominately a mechanism by which a distressed debtor auctions off the entire firm, remitting the proceeds of the sale to the various creditor classes. Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 Stan. L. Rev. 673, 675-76 (2003) (noting that 56% of debtors use Chapter 11 to auction their assets). "In high-stakes cases, bankruptcy judges now serve primarily as auctioneers." Vincent S. J. Buccola & Ashley C. Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 Geo. Mason L. Rev. 99, 99 (2010). The important question that remains is how they should structure the auctions over which they preside in order to maximize creditor recoveries.

The petition for certiorari raises an important and timely issue in this vein: whether secured creditors are entitled to credit bid at bankruptcy auctions. To appreciate the importance of the question presented, a brief explanation of credit bidding is in order. Simply put, "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." *Id.* at 102 (providing a detailed mathematical model for credit bidding). Suppose that debtor D owes $100 to secured creditor C, whose security interest extends to D's only asset, a widget. If C values the widget at $60, a credit bid for that price is C's offer to reduce D's $100 liability to $40 ($100 minus $60) in exchange for C taking ownership of the widget. For all intents and purposes, C is using $60 worth of his $100 credit as cash-equivalent currency at the bankruptcy auction.

As far as the bankruptcy estate is concerned, a winning credit bid replicates the results of a winning cash bid. *Ibid.* Returning to the example above, suppose that C is prohibited from bidding credit. To fund his bid, C must take out a $60 loan from Bank. At auction, C submits a winning $60 cash bid for the widget, remitting the borrowed funds over to D. Now D immediately returns the $60 to C. (As the secured creditor, C has a right to sale proceeds up to the amount of his security interest. 11 U.S.C. § 506(a).) C then uses the $60 to repay his short-lived loan to Bank. Just as in the credit bidding example, the cash-only auction ends with C in possession of the widget and D still in C's debt to the tune of $40. Whether C's payment comes in the form of cash or credit does not affect D's bottom line, and hence does not affect the rights of D's general creditors or other junior claimants. Buccola & Keller, *supra*, at 103-04.

Of course the highly stylized assumptions of the simplistic hypothetical above do not hold in practice. In real-world bankruptcy auctions, credit bidding provides three principal benefits that permit the debtor's assets to sell for the highest possible price.

First, credit bidding offers an effective check against management malfeasance. Not all debtors faithfully discharge their obligation to maximize estate value. 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. The proposed sale in *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 319-20 (3d Cir. 2010) (Ambro, J., dissenting), may illustrate this very sort of managerial dereliction of duty. Creditors, who bear the costs of a rigged auction, are naturally inclined to prevent inefficient sales. Alan Schwartz, *The Enforceability of Security Interests in Consumer Goods*, 26 J.L. & Econ. 117, 126-27 (1983). Credit bidding helps them do so. In short, the best check against a fixed auction is to increase the stock of knowledgeable bidders interested in purchasing the debtor's collateral.

Second, credit bidding reduces transaction costs. This increases the maximum bid a credit bidder is willing to submit for the assets up for sale. In our hypothetical, we assumed that C could borrow $60 from Bank to bid on the widget, returning the same $60 after winning the auction. In actual practice, banks charge fees and interest. Each dollar C pays in financing costs reduces by a dollar the price he will be willing to bid on the assets the debtor proposes to sell. Buccola & Keller, *supra*, at 121. And reducing the maximum amount a bidder is willing to bid reduces the expected proceeds from an auction.

In the hypothetical, we need only consider the minimal transaction costs on a $60 loan. Unsurprisingly, the stakes are typically higher. In this case, the secured creditors would need to secure $142 million to bid the full amount of their secured claim in cash. (Pet. for Writ of Certiorari at 4.) And the creditors in *Philadelphia Newspapers* and *Pacific Lumber* (the cases that constitute the other side of the circuit split) would have required $300 million and $740 million respectively to bid their debts in cash. *See Philadelphia Newspapers*, 599 F.3d at 301; *In re Pacific Lumber Co.*, 584 F.3d 229, 237 (5th Cir. 2009). Putting together multi-hundred-million dollar loans comes at a cost of millions of dollars in fees and interest. Authorizing credit bidding avoids those costs, increasing the expected proceeds from a bankruptcy auction.

A third benefit of credit bidding is that it increases the pool of knowledgeable bidders participating at a bankruptcy auction, upping competition for the items on the auction block. Increased competition tends to increase the price of the eventual winning bid. Buccola & Keller, *supra*, at 119. Auction optimization theory instructs that the bidders with the highest and second-highest reservation prices will determine the winning sale price. Competition between bidders drives the price of the asset to that of the bidder with the second-highest reservation price, at which point the high-value bidder will submit an incrementally higher topping bid, winning the auction. *See Van Zelst v. Commissioner*, 100 F.3d 1259, 1262 (7th Cir. 1996) ("[T]he market price of an asset depends on the second-most-productive use to which it can be put."). Barring credit bidding creates risk that the would-be credit bidder will be unable to secure cash financing in time to participate in the bankruptcy auction. And keeping a credit bidder from the auction risks excluding the high-value or second-highest-value bidder, reducing the expected winning price for the debtor's assets.

## II. Reasons for Granting the Petition for Certiorari

As a matter of economics, "credit bidding is an unalloyed good" for a debtor's estate. Buccola & Keller, *supra*, at 120. But sound policy and the law do not always mesh. Traditionally, bankruptcy sales were conducted under 11 U.S.C. § 363, which textually assures the right of creditors to credit bid save for "cause." 11 U.S.C. § 363(k). Yet debtors have come to realize that they may also sell all of their assets pursuant to a plan of reorganization under 11 U.S.C. § 1129(b)(2)(A). As petitioners argue, at least one reading of that statutory provision authorizes asset sales without affording a creditor the right to credit bid. 11 U.S.C. § 1129(b)(2)(A)(iii). The correct interpretation of § 1129(b)(2)(A) has divided the Courts of Appeals. The Third and Fifth Circuits have held that the statute does not assure the right to credit bid. *See Philadelphia Newspapers*, 599 F.3d 298; *Pacific Lumber*, 584 F.3d 229. The Seventh Circuit below held squarely to the contrary. Resolving the circuit conflict over this important question is worthy of the Court's attention. *See* S. Ct. R. 10(a).

*Amici* will not repeat the argument of the petition for certiorari, which ably describes the split between the courts of appeals. Even when the courts of appeals are divided, however, this Court often elects not to resolve shallow splits. For at least four reasons, *amici* respectfully argue that this petition is grant-worthy notwithstanding the fact that the split only involves three courts of appeals.

First, a reason to deny shallow splits is to permit a question to receive more comprehensive treatment in the lower courts. Courts of appeals often address matters in a cursory or oblique fashion. When that is so, prudence may counsel in favor of permitting an issue to percolate further, enabling this Court to weigh in only after the contours of an issue have crystallized. The benefits of further percolation do not apply here. Between them, the Third, Fifth, and Seventh Circuits have issued four published opinions filling some 78 pages of the Federal Reporter. The decision in *Pacific Lumber* denying the right to credit bid was authored by Chief Judge Jones, a former bankruptcy practitioner who served as one of Chief Justice Rehnquist's appointees to the National Bankruptcy Review Commission. And Judge Ambro penned a dissent in *Philadelphia Newspapers* contending that § 1129 guarantees the right to credit bid at bankruptcy auctions. Like Judge Jones, Judge Ambro is a former bankruptcy practitioner who has authored some of the most important opinions in the field. *See, e.g.*, *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005). Awaiting further analysis from other circuits will add negligible value.

Second, bankruptcy cases face unique obstacles to appellate review, obstacles that often preclude the development of deep splits concerning the law of reorganization. Once consummated, plans of reorganization have immediate financial consequences for a debtor's stakeholders: new, publicly traded equity is often issued, old liabilities are discharged, corporate divestitures are implemented, and tax losses are realized. *See, e.g.*, *In re UNR Indus., Inc.*, 20 F.3d 766, 769 (7th Cir. 1994). Undoing the effects of even an erroneously approved plan of reorganization would often prove difficult and highly disruptive. As a result, the courts of appeals have long applied a doctrine, dubbed "equitable mootness," that constrains appellate review of consummated plans. *E.g.*, *In re Pub. Serv. Co.*, 963 F.2d 469, 471-72 (1st Cir. 1992); *In re Manges*, 29 F.3d 1034, 1039 (5th Cir. 1994); *In re Roberts Farms, Inc.*, 652 F.2d 793, 796-97 (9th Cir. 1981); *In re Club Assocs.*, 956 F.2d 1065, 1069 (11th Cir. 1992); *see also UNR Indus.*, 20 F.3d at 769 (explaining that equitable mootness is a doctrine of prudence having nothing to do with the existence of a case or controversy). Whether credit bidding is statutorily assured or not, so-called equitable mootness may deter other appellate courts from reviewing the merits of a plan of reorganization that authorizes (or forbids) the procedure.

Third, due to an unusual ability for debtors to forum shop, it is especially important for the Bankruptcy Code to receive a uniform national construction. Chapter 11 debtors are authorized to file a bankruptcy petition in any district in which they reside, are domiciled, have their principal place of business, hold their principal assets, *or* in which an affiliated entity has commenced a bankruptcy case. 28 U.S.C. § 1408. Most large corporate debtors thus can choose their venue and, with it, their preferred interpretation of the Bankruptcy Code. A debtor determined to deny creditors the right to credit bid will often find it easy to file for bankruptcy in the Fifth or Third (as opposed to the Seventh) Circuit. That is especially so given the large number of companies incorporated in Delaware, which falls within the Third Circuit.[2]

Finally, the question presented by the petition is an important one. The Federal Reserve estimates that American businesses are capitalized with nearly $11 trillion in debt, much of which is secured. *See* http://www.federalreserve.gov/releases/z1/current/z1r-2.pdf (last visited August 14, 2011). And the value of secured debt is determined in significant part by the

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[2] Because most courts have held that a corporate debtor is domiciled where it is incorporated, *see* Michael P. Cooley, *Will Hertz Hurt? The Impact of Hertz Corp. v. Friend on Bankruptcy Venue Selection*, Am. Bankr. Inst. J. 28, 85 (2010) (collecting cases), countless debtors will be able to take advantage of the decision in *Philadelphia Newspapers*.

rights secured creditors enjoy in the event of bankruptcy. *See* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 Yale L.J. 857, 868 (1982). Whether secured creditors are entitled to credit bid, therefore, "likely holds tens of billions of dollars in the balance." Buccola & Keller, *supra*, at 100. Given the stakes, the Court should not permit even a shallow division between the courts of appeals to persist.

## CONCLUSION

The Court should grant the petition for a writ of certiorari.

Respectfully Submitted,

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