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LIMITING CREDIT BIDDING FOR “CAUSE” UNDER § 363(K): CONTRA *PHILADELPHIA NEWSPAPERS* FOOTNOTE 14

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Recently, the American Bankruptcy Institute (the “ABI”) Commission to Study the Reform of Chapter 11 released its 2012-2014 Final Report and Recommendations.¹ There, the ABI Commission acknowledged “the fundamental role of credit bidding under state law and section 363(k)” and that “all credit bidding chills an auction process to some extent.”² The Commissioners stated that they “did not believe that the chilling effect of credit bids alone should suffice as cause under section 363(k).”³ The Commissioners implicitly rejected the contrary reading of “cause” tendered by the Third Circuit in *In re Philadelphia Newspapers, LLC*, and both cited and seemingly applied, to some degree, in *In re Fisker Automotive Holdings, Inc.*, and *In re The Free Lance-Star Publishing Co. of Fredericksburg, Va.*⁴ Throughout the present discussion, we will refer to the reading of “cause” tendered in *Philadelphia Newspapers* and rejected by the ABI Commission as the “In and Of Itself” reading, for it would justify a finding of “cause” to limit credit bidding in a bankruptcy sale based on the chilling effect of credit bidding in and of itself.

We agree with the Commission’s rejection of the In and Of Itself reading of “cause” in section 363(k). Below we trace the outlines of arguments that: (a) the In and Of Itself reading of “cause” has no precedent prior to *Philadelphia Newspapers* and is scarcely supported there; (b) application of the In and Of Itself reading is not justified on policy

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¹ AM. BANKR. INST. COMM’N TO STUDY THE REFORM OF CHAPTER 11 FINAL REPORT AND RECOMMENDATIONS (2014).

² *Id.* at 147.

³ *Id.*

⁴ See *In re Phila. Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010); *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55 (Bankr. D. Del. 2014); *In re Free Lance-Star Publ’g. Co.*, 512 B.R. 798 (Bankr. E.D. Va. 2014).

grounds, as is proposed by *Philadelphia Newspapers*; and (c) application of the In and Of Itself reading would effect a compensable taking under the Fifth Amendment to the United States Constitution.

Section 363(k) and “Cause”

Section 363(k) of the Bankruptcy Code reads *in toto* as follows:

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.⁵

As discussed in Jonathan Brand and Jonathan Friedland’s “You Know About Fisker But Do You Understand Fisker?,” there are traditional bases on which courts have limited credit bidding under section 363(k).⁶ First, challenges to the validity, priority, and extent of liens on the collateral in question have been brought to bear under section 363(k). The credit bidding rights provided or recognized in section 363(k) are conditioned: the credit bidder must be the holder of an “allowed claim” with a lien on the property to be sold that secures the allowed claim. That condition might be considered to form the basis upon which a credit bidding right is limited due to defects in the validity, priority, and extent of liens over the collateral in question. Nevertheless, such lien defects or claim allowance issues are often characterized as constituting “cause” to limit credit-bidding rights.

“Cause” in section 363(k) extends beyond lien defects or claims allowance issues. Most prosaically, credit-bidding rights can be defeated by the creditor’s failure to assert them in accordance with procedural orders in the case. For example, in *In re Antaeus Technical Services, Inc.*, the court held that the expiration of certain deadlines per a settlement agreement between debtor and secured creditor resulted in bargained-for abandonment of its rights, including credit-bidding rights, in the principal asset to be sold.⁷

⁵ 11 U.S.C. § 363(k) (2012).

⁶ See Jonathan Brand & Jonathan Friedland, *You Know About Fisker But Do You Understand Fisker?*, 31 THE BANKR. STRATEGIST 9 (2014).

⁷ *In re Antaeus Technical Servs., Inc.*, 345 B.R. 556 (Bankr. W.D. Va. 2005).

Also, inequitable behavior or misconduct by the secured creditor can constitute “cause” to limit credit bidding rights of the holder of an allowed claim that has none of the lien defects or allowance issues mentioned above. Penalizing the holder of an allowed claim for its misconduct by limiting credit bidding rights mirrors the application of section 510(c) of the Code, by which a court may “under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim”⁸ It is uncontroverted that, like lien defects, claim allowance issues, and procedural defaults, a credit bidder’s inequitable conduct can support a court’s limitation of credit-bidding rights under section 363(k).

No Support for the In and Of Itself Reading of “Cause”

The In and Of Itself reading of “cause” in section 363(k) purports to authorize limiting credit bidding rights even in the absence of lien defects, claim allowance issues, procedural defaults, and inequitable conduct. The In and Of Itself reading is based solely upon the inevitable effect that exercise of a credit bidding right -- in particular where the secured claim at first glance exceeds the cash value of the collateral -- has on an auction sale of property of the debtor in a bankruptcy case. We cannot distinguish between that effect and the effect caused by a cash bidder clearly able and willing to pay more than any other bidder, but let us leave that to the side.

The *Fisker* and *Free Lance-Star* opinions contain language that endorses the In and Of Itself basis for the finding of “cause.”⁹ We note that Brand and Friedland argue that both cases can be explained by traditional and uncontroversial analyses described above, *i.e.*, that credit-bidding rights were limited in those cases because of unresolved issues over validity, priority, and extent of liens, as well as over inequitable behavior by the secured creditors.¹⁰

In their references of the In and Of Itself reading of “cause,” the *Fisker* and *Free Lance-Star Publishing* courts drew from the fountainhead of text leading up to footnote 14 in the *Philadelphia Newspapers* majority

⁸ 11 U.S.C. § 510(c) (2012).

⁹ See, *In re Fisker*, 510 B.R. 55 (Bankr. D. Del. 2014); *In re The Free Lance-Star*, 512 B.R. 798 (Bankr. E.D. Va. 2014).

¹⁰ See Brand & Friedland, *supra* note 6.

opinion and from the footnote itself (none of the Court's assertions in such text was at issue in *Radlax Gateway Hotel, LLC v. Amalgamated Bank*, which overruled the major holdings of *Philadelphia Newspapers*).¹¹ Both opinions cite the same four cases the Third Circuit cited in that discussion.¹²

Those four cases cited are *In re Aloha Airlines*, *Greenblatt v. Steinberg*, *In re Anteaus Technical Services, Inc.*, and *In re Theroux*.¹³ In none of the cases cited by the Third Circuit did the court apply the In and Of Itself reading of "cause" to limit credit bidding. Each featured inequitable behavior, procedural default, or lien defects. That should not surprise anyone, for the *Philadelphia Newspapers* court cited the cases to support the uncontroversial proposition that "[i]n a variety of cases where a debtor seeks to sell assets pursuant to § 363(b), courts have denied secured lenders the right to bid their credit," and not the more radical proposition that credit bidding has been denied solely because it might chill bidding.¹⁴

At footnote 14 in the opinion, the Third Circuit declares in favor of application of the In and Of Itself reading of "cause" and cites its sole authority for the declaration:

The Lenders argue that the "for cause" exemption under § 363(k) is limited to situations in which a secured creditor has engaged in inequitable conduct. That argument has no basis in the statute. A court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment. *See, e.g.*, 3 Collier on Bankruptcy 363.09[1] ("The Court might [deny credit bidding] if permitting the lienholder to bid would chill the bidding process.")¹⁵

¹¹ *See In re Fisker* 510 B.R. 55; *In re Free Lance-Star*, 512 B.R. 798; *In re Phila. Newspapers, LLC*, 599 F.3d 298, 329 (3d Cir. 2010); *Radlax Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012).

¹² *See In re Fisker*, 510 B.R. at 59-60; *In re Free Lance-Star*, 512 B.R. at 805.

¹³ *In re Aloha Airlines, Inc.*, 2009 Bankr. LEXIS 4348, 2009 WL 1371950 (Bankr. D. Haw. May 14, 2009); *Greenblatt v. Steinberg*, 339 B.R. 458 (N.D. Ill. 2006); *In re Anteaus Technical Servs., Inc.*, 345 B.R. 556 (Bankr. W.D. Va. 2005); *In re Theroux*, 169 B.R. 498 (Bankr. D. R.I. 1994).

¹⁴ *In re Phila. Newspapers*, 599 F.3d at 315.

¹⁵ *Id.* at 316, n.14 (referencing 3 COLLIER ON BANKRUPTCY ¶ 363.09[1] (16th ed 2015)).

In summary, the fountainhead for the In and Of Itself reading of “cause” presented in *Fisker* and *Free Lance-Star Publishing* -- a radical break with prior law -- was dicta buried by the *Philadelphia Newspapers* court in a footnote, supported solely by reference to a treatise, which itself cited nothing, as it was talking about something completely different, and which was selectively edited by the court to suit its unrelated purposes.

“A court may deny a lender the right to credit bid in the interest of any policy advanced by the . . . Code”²²

Leaving aside the notional support for the In and Of Itself reading, let us consider whether, as *Philadelphia Newspapers* would have it, “the interest of any policy of the Code” suffices to authorize a court to limit or deprive an otherwise valid credit bidding right in a bankruptcy sale.²³

Bankruptcy courts are not courts of policy. They are bound to apply the statute as written, subject to authoritative canons of interpretation. It follows, then, that Code policies are found only in Code provisions. Courts and advocates can tease a “policy” from any of the hundreds of provisions in the Code to deploy against a contrary teased-out policy. Such advocacy can provide only the lightest support for a radical change in interpretation of the meaning of “cause” in section 363(k).

The *Philadelphia Newspapers* majority’s footnote 14 identified policies (ensuring the success of the reorganization or fostering a competitive bidding environment), but did not identify any provisions that substantiate them or weigh such policies against other policies.²⁴

With a moment’s consideration, even weary and distracted commentators can summon the priority of payment rules of section 507, the absolute priority rule of section 1129(b), and the secured creditor’s election provided under section 1111(b) as substantiating a Code policy in favor of preserving important secured creditor rights.²⁵ For that matter, such commentators could also cite section 363(k) itself, and its application to plan sales via section 1129(b)(2)(A)(ii), in support of the same policy.²⁶ In his *Philadelphia Newspapers* dissent, Judge Ambro

²² *In re Phila. Newspapers*, 59 F.3d at n.14.

²³ *Id.*

²⁴ *Id.*

²⁵ *See* 11 U.S.C. § 507 (2012); 11 U.S.C. § 1129(b) (2012); 11 U.S.C. § 1111(b) (2012).

²⁶ *See* 11 U.S.C. § 363(k) (2012); 11 U.S.C. 1129(b)(2)(A)(ii) (2012).

discussed at some length such statutory provisions as constituting “part of a comprehensive arrangement enacted by Congress to avoid the pitfalls of undervaluation, regardless of the mechanism chosen, and thereby ensure that the rights of secured creditors are protected while maximizing the value of collateral to the estate and minimizing deficiency claims against other unencumbered assets.”²⁷

In and Of Itself “Cause” Effects a Taking

The secured creditor acquires its credit bidding rights by taking appropriate steps under non-bankruptcy law to attach and perfect a lien on collateral. The right to credit bid entitles the secured creditor to take the collateral if not outbid with cash. Section 363(k) expressly acknowledges that right.²⁸ The right to credit bid at a bankruptcy sale is a significant property right.²⁹

Unsecured creditors do not take such steps to gain such rights. The In and Of Itself basis of “cause” would deprive the secured creditor’s bargained-for credit-bidding rights and thus benefit non-creditor bidders (who did not bargain for credit-bidding rights) to acquire the collateral with cash. What policy justifies such a windfall? Based upon which provisions of the Code? On its face, the In and Of Itself reading of “cause” is a standardless deprivation of the property of A in order to benefit B.

In *Palazzolo v. Rhode Island*, the Supreme Court reviewed Takings jurisprudence, in particular regulatory takings (where government affects and limits use of property to an extent that requires compensation).³⁰ The Takings Clause of the Fifth Amendment prohibits the government from taking private property for public use without just compensation.³¹

In *Armstrong v. United States*, the Court described the purpose of the Takings Clause as “to prevent the government from ‘forcing some

²⁷ *In re Phila. Newspapers*, 599 F.3d at 334 (Ambro, J., dissenting).

²⁸ *See* 11 U.S.C. § 363(k) (2012).

²⁹ *See* *Louisville Stock Land Bank v. Radford*, 295 U.S. 555, 594 (1935).

³⁰ *See* *Palazzolo v. Rhode Island*, 533 U.S. 606 (2001).

³¹ U.S. CONST. amend. V; *Palazzolo*, 533 U.S. at 617.

people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.”³² The “some people” in that case were holders of mechanics lien rights regarding boats and materials, of which they had been deprived upon transfer of the boats and materials to the U.S. government.³³ The Court held that the holders of mechanics lien rights were entitled to recover whatever value their liens had when the Government took title to the boats and materials.³⁴ The same principle should apply to protect secured creditors’ credit-bidding rights if taken under the In and Of Itself reading of “cause” in section 363(k).

The *Palazzolo* Court, citing *Penn Central Transportation Company v. City of New York*, recognized that where a regulation places a limitation on property that falls short of eliminating all economically beneficial use, “a taking nonetheless may have occurred, depending upon a complex of factors including the regulation’s economic effect on the [owner], the extent to which the regulation interferes with reasonable investment-backed expectations, and the character of the government action.”³⁵

There is no doubt that application of the In and Of Itself reading of “cause” in section 363(k) to diminish or deprive credit bidding rights raises risks of economic deprivation to the secured creditor (in particular of receiving less for the collateral) and upends its reasonable, investment-backed expectations on which the secured creditor relied in lending cash to the borrower. In his dissent in *Philadelphia Newspapers*, Judge Ambro identified several aspects of the reasonable investment-backed expectations of secured lenders who acquire credit-bidding rights:

- reliance that the bargain freely and legally entered into by the parties would be enforced;
- reliance upon credit-bidding rights in reducing pricing and costs in accordance with the contractual bargain struck with borrower - - without such reliance, secured creditors would have to adjust their pricing, possibly by raising interest rates or reducing credit availability to account for the possibility of a sale of the collateral without credit bidding;

³² *Armstrong v. United States*, 364 U.S. 40, 49 (1960).

³³ *See generally* *Armstrong*, 364 U.S. 40.

³⁴ *Id.* at 49.

³⁵ *Palazzolo*, 533 U.S. at 617-18 (citing *Penn Cent. Trans. Co. v. City of New York*, 438 U.S. 104, 124 (1978)).

· reliance upon credit-bidding right to ensure proper valuation of the collateral at a sale free of liens.³⁶

As to the character of the government action aspect of the Takings analysis, the *Penn Central* Court reviewed various possible factors, including the importance of the governmental policy being advanced, the uniformity of the statute’s application to similar property rights, and the arbitrariness of the governmental decision to deprive.³⁷ As discussed above, with respect to the In and Of Itself reading of “cause” in section 363(k), the governmental policy served is obscure. Further, the In and Of Itself reading is not a statute, and as a judicial gloss serving an obscure policy, it is certain to engender non-uniform and arbitrary rulings. The public hammer will hit this or that secured creditor, but not the other, “forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.”³⁸

³⁶ *In re Phila. Newspapers, LLC*, 599 F.3d 298, 337 (3d Cir. 2010) (Ambro, J., dissenting).

³⁷ *Penn Central*, 438 U.S. at 123-35.

³⁸ *Armstrong*, 364 U.S. at 49.

